THE REVENUE-INCREASING MEASURES IN THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

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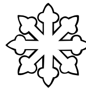

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THE REVENUE-INCREASING MEASURES IN THE "SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007"

WEDNESDAY, MARCH 14, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The Committee met, pursuant to notice, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (Chairman of the Committee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

FOR IMMEDIATE RELEASE CONTACT: (202) 225–3625
March 07, 2007
FC–11

Chairman Rangel Announces Hearing on the Revenue-Increasing Measures in the "Small Business and Work Opportunity Act of 2007"

House Ways and Means Committee Chairman Charles B. Rangel (D–NY) today announced that the Committee will hold a hearing on the revenue-increasing measures that are included in the Senate-passed version of H.R. 2, the "Small Business and Work Opportunity Act of 2007." **The hearing will take place on Wednesday, March 14, 2007, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

On January 10, 2007, the House of Representatives passed H.R. 2, the "Fair Minimum Wage Act of 2007," which would increase the Federal minimum wage for the first time in ten years. On February 1, 2007, the Senate passed its own version of H.R. 2. The Senate-passed version coupled an increase in the Federal minimum wage with a package of tax benefits costing $8.3 billion over ten years. In order to offset the cost of these tax benefits, the Senate bill includes over a dozen separate provisions that, in the aggregate, would raise $8.3 billion over ten years. These offsetting revenue increases would, among other things, change the tax treatment of certain leases entered into before March 12, 2004, deny deductions for certain government-required payments and punitive damages in civil actions, enact new limitations on deferred compensation plans, and change the tax treatment of certain financial instruments. The Committee on Ways and Means has not held prior hearings on these issues.

In announcing the hearing, Chairman Rangel said, **"The Senate tax relief package includes a number of revenue-raising provisions that would have a significant impact on the business community. Since the Senate-passed bill was intended to help offset the costs associated with an increase in the Federal minimum wage, it seems only fair that the business community should be given an opportunity to explain the effect these revenue increases would have on businesses."**

FOCUS OF THE HEARING:

This hearing will focus on the impact that the revenue increases included in the "Small Business and Work Opportunity Act of 2007" would have on businesses.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, *http://waysandmeans.house.gov*, select "110th Congress" from the menu entitled,

"Committee Hearings" (*http://waysandmeans.house.gov/Hearings.asp?congress=18*). Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the online instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You MUST REPLY to the email and ATTACH your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business **Wednesday, March 28, 2007**. Finally, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225–1721.

FORMATTING REQUIREMENTS:

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and MUST NOT exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at *http://waysandmeans.house.gov*.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman RANGEL. Good morning. As you know, we are supposed to be going to conference with the Senate on the minimum wage bill. This Committee did provide a $1.3 billion tax relief bill for small businesses.

However, even though there is no indication when we are going to conference, they have begun an $8.6 billion tax bill, and many of the Members of this Committee have been approached by people who would be affected by the provisions in the Tax Code they have suggested would pay for the $8.6 billion.

Since when we go to conference, these issues would be in contention, the ranking Member and I thought that the Members of the Committee should have a better understanding of what we will be faced with in the conference. So, I look forward to hearing from the witnesses, and it's with great pleasure that I yield to the ranking Member, Mr. McCrery, for opening remarks.

Mr. MCCRERY. Thank you, Mr. Chairman. Thank you, in particular, for calling this hearing today to explore several tax increases recently passed by the Senate in conjunction with an increase in the minimum wage.

My position on the small business tax relief bill is well-documented. I have told virtually anyone who will listen that Congress needs to provide more tax relief to small businesses, in particular, to help offset the cost of the minimum wage increase. These small businesses are crucial to the growth of our economy.

As the Congressional Budget Office pointed out, a minimum wage increase will impose, over the next five years, a burden on employers of more than $16 billion. Thus, it would be my preference to see an even larger tax package than the one approved by the House last month. I would even like the total amount of relief to be greater than the $8 billion in the Senate-passed bill.

We cannot ignore the requirements imposed upon us by the new pay-as-you-go (PAYGO) rules. Early experience with these rules suggests to me that avoiding an ill-advised tax increase can be just as important, and sometimes maybe even more so, than an acting on desirable tax relief. Today's hearing will give us an opportunity to hear directly from some of those who would be most effected by the revenue-raising proposals in the Senate-passed bill.

I look forward to gaining a better understanding of the impact of these items, and I yield back the balance of my time.

Chairman RANGEL. Our first witness would be the Honorable Kenneth Bentsen, president of Equipment Leasing and Finance Association (ELFA), from Arlington, Virginia. Thank you.

STATEMENT OF THE HONORABLE KENNETH E. BENTSEN, JR., PRESIDENT, EQUIPMENT LEASING AND FINANCE ASSOCIATION, ARLINGTON, VIRGINIA

Mr. BENTSEN. Thank you, Mr. Chairman, Ranking Member McCrery, and Members of the Committee. Mr. Chairman, I would ask that, if I could, summarize my statement to stay within the 5 minutes.

I appreciate the opportunity to present the views of ELFA on the proposal contained in the Senate-passed version of H.R. 2, the Small Business and Work Opportunity Act of 2007, that we believe would retroactively impose taxes on certain cross-border leasing transactions.

The ELFA is a trade association representing 770 members, including banks, financial services companies, and manufacturers in the equipment finance industry. Our members are engaged in a broad sector of commercial finance, including business-to-business leasing and financing of capital equipment and software. Our industry's members are the major financiers of transportation, manufacturing, mining, medical, office, construction, information, and technology equipment, and our members' customers include Fortune 100 companies, small and medium-sized enterprises, and State and local governments.

Nearly 3 years ago, Congress passed the American Jobs Creation Act of 2004 (P.L. 108–357). As part of that legislation, and in response to concerns regarding certain domestic and cross-border leasing transactions, Congress created a new section of the tax

code, Internal Revenue Code section 470, which applies a passive-loss type regime to certain leasing transactions involving property used by governments or other tax-exempt entities.

Importantly, in 2004, Congress recognized a sweeping change in law as a policy change, and decided on a prospective effective date which applies to the new rules to leases entered into after March 12, 2004.

Moreover, the conferees specifically decided that no inference is intended regarding the appropriate present law tax treatment of transactions entered into prior to the effective date, namely that no intent was given with respect to the appropriateness of transactions entered into that prior effective date.

To go back now and retroactively change the agreement is, in effect, reopening the conference negotiations between the House and the Senate 3 years later, and creating double jeopardy for taxpayers. The proposal in the Senate version would undermine the decisions made by the conferees of the Jobs Act, and retroactively change the effective date for cross-border leases entered into on or before March 12, 2004.

Specifically, the Senate proposal would reach back and impose taxes that could never have been expected on transactions that were completed years before the original jobs act was ever contemplated. Indeed, under recently issued Financial Accounting Standards Board (FASB) guidance, any change of the timing of cashflows caused by changes in the tax treatment of a lease will require recalculation of earnings dating back to the inception of the lease.

As a consequence, the Senate provision would result in significant new tax liabilities on U.S. taxpayers, as well as significant adverse financial statement consequences caused by such recomputations for those affected U.S. companies which are publicly listed.

Additionally, as crafted, the provision would result in consequences for transactions never targeted by the proponents or the Government. As an example, one of our members states that the proposed retroactive change in section 470 would eliminate net deductions for tax years 2007 and beyond on a number of lease transactions entered into years ago that the Internal Revenue Service (IRS) does not consider abusive.

The Committee on Ways and Means appropriately rejected the Senate proposal earlier this year in developing the House version of the Small Business Tax Relief Act of 2007. In fact, Mr. Chairman, you wisely stated that such retroactive tax changes were "bad policy."

We also believe that this provision undermines taxpayer due process. Proponents of the provision have asserted that the provision would be beneficial to the IRS in litigation efforts against certain U.S. taxpayers involved in such transactions. Ultimately, any legal issues surrounding the transactions completed prior to the Jobs Act effective date would be—should and will be properly addressed by the IRS in the courts on the basis of the laws that were in effect at the time of the transactions.

On due process grounds alone, U.S. taxpayers deserve to have their day in court, without interference from the Congress, before

any judgement has been rendered. To date, there have been no judgements involving such cross-border transactions.

Furthermore, nothing in the Senate provision would preclude—nor could the taxpayer expect—that the Government would discontinue to pursue a case against the taxpayer, as such cases relate to tax treatment of prior years. If this is allowed, there is no reason Congress could not simply retroactively change the law and favor the IRS on any issue the IRS is currently challenging in the courts, or otherwise. This is not the way our U.S. rule of law works, and it's not a change this Committee should endorse.

With all due respect to the proponents, I would submit to the Committee that the issue before the congress is not the merits of the underlying transactions in question, as many of those are properly being reviewed by the IRS on independent facts and circumstances, just as Congress intended.

The real issue is one of policy and process, the use of retroactive tax law changes to raise revenue, as the Senate version of H.R. 2 clearly does, and the due process rights of taxpayers, which the Senate bill undermines. We believe such actions are fundamentally unfair and unwise.

[The prepared statement of Mr. Bentsen follows:]

Statement of The Honorable Kenneth E. Bentsen, Jr., President, Equipment Leasing and Finance Association, Arlington, Virginia

Mr. Chairman, Ranking Member McCrery, and members of the Committee, thank you for the opportunity to present the views of the Equipment Leasing and Finance Association (ELFA) on the proposal contained in the Senate-passed version of H.R. 2 the "Small Business and Work Opportunity Act of 2007," that would retroactively impose taxes on certain cross-border leasing transactions.

ELFA is a trade association representing 760 members, including banks, financial services companies, and manufacturers, in the equipment finance industry. ELFA's members are engaged in a broad sector of commercial finance including business-to-business leasing and financing of capital equipment and software. The industry size, domestically, is estimated to comprise one-third of fixed business investment annually and its members are the major financiers of the transportation (aircraft, maritime, rail, and trucking), manufacturing, mining, medical and office equipment, construction and information technology fields. Our members' customers include Fortune 100 companies, small and medium sized enterprises, and state and local governments. Our members also provide financing for equipment globally, much of it domestically produced.

Nearly three years ago, Congress passed the American Jobs Creation Act of 2004 (Pub. Law 108–357) (the "JOBS Act"). As part of that legislation, and in response to concerns regarding certain domestic and cross-border leasing transactions, Congress created a new section of the tax code, IRC section 470, which applies a "passive-loss" type regime to certain leasing transactions involving property used by governments or other tax-exempt entities. Generally, under the provision tax losses incurred over the course of the lease are deferred and offset against future income from the property. The provision contains an exception if a taxpayer meets the requirements of all of four specifically described rules involving certain types of property, availability of funds, and where the lessor makes a substantial equity investment, and the lessee does not bear more than a minimal risk of loss.

Importantly, in 2004, Congress recognized this sweeping change in law as a policy change and decided on a prospective effective date which applies the new rules to leases entered into *after March 12, 2004.* Certain grandfather rules were also provided to avoid retroactive application of the new regime.

Moreover, the conferees specifically decided that "[N]o inference is intended regarding the appropriate present-law tax treatment of transactions entered into prior to the effective date," . . . namely that no intent was given with respect to the appropriateness of transactions entered into prior to the effective date. See, H. Rpt. 108–755, p. 647, 650. To now go back and retroactively change this agreement is in effect reopening the conference negotiations between the House and the Senate 3 years later and creating "double jeopardy" for taxpayers.

RETROACTIVE TAX INCREASE

The current proposal in the Senate version of H.R. 2 would undermine the decisions made by the conferees of the JOBS Act and retroactively change the effective date of IRC section 470 for cross-border leases entered into *on or before March 12, 2004*. The Senate proposal would reach back and impose taxes that could never have been expected on transactions that were completed years before the original JOBS Act was ever contemplated.

The Ways and Means Committee appropriately rejected the Senate proposal earlier this year in developing the House version of the "Small Business Tax Relief Act of 2007" (H.R. 976) on February 12, 2007. And, in fact, Mr. Chairman you wisely stated that such retroactive tax changes were "bad policy."

Proponents of the retroactive change to Section 470 as contained in the Senate bill assert that the provision is: a) not retroactive because it applies to future tax years albeit of transactions completed prior to March 12, 2004; and b) necessary to relieve the Internal Revenue Service of the burden of challenging certain transactions on economic substance and other grounds. Proponents further argue that the facts related to the transactions in question justify such actions.

In fact, as crafted: the provision is retroactive, the provision will result in consequences for transactions never targeted by the proponents or the government, and the provision will undermine taxpayer's due process rights.

With all due respect to the proponents of the Senate provision, I would submit to the Committee that the issue before the Congress is not the merits of the underlying transactions in question, as many of those are properly being reviewed by the IRS based on independent facts and circumstances, just as the Congress intended. The real issue is one of policy and process—the use of retroactive tax law changes to raise revenue, as the Senate version of H.R. 2 clearly does; and the due process of taxpayers, which the Senate bill undermines. We believe such actions are fundamentally unfair and unwise.

If retroactive tax policy is pursued in this instance, there is no reason retroactivity would not be pursued elsewhere thus undermining all reliance on our U.S. tax laws. The imposition of this retroactive provision would result in irreparable damage to investor confidence in the leasing market going forward, and impede the Congress' ability to utilize the tax code as a means to spur investment. For this reason, the Congress historically has opposed such retroactive tax policy.

RECOMPUTATION OF U.S. TAXPAYER'S BOOKS

Proponents of the Senate provision have asserted that the proposal is not retroactive because it applies to taxable years beginning after December 31, 2006. Clearly this is incorrect as the proposal applies to leases executed years ago. Indeed, under recently issued FASB guidance (FSP FAS 13–2), any change in the timing of cash flows caused by changes in the tax treatment of a lease will require a recalculation of earnings dating back to the inception of the lease. As a consequence, the Senate provision would result in significant new tax liabilities on U.S. taxpayers and significant adverse financial statement consequences caused by such recomputations for those affected U.S. companies which are publicly listed.

The retroactive impact on a taxpayer's books under FASB rules is described in more detail in an attachment, hereto.

The bottom line is that the provision would have the effect of disrupting the economics of multiyear transactions entered into years ago by U.S. financial institutions in reliance on existing law. This is exacerbated since the Senate provision would be unlimited in its application and would apply to transactions completed well into the last century, long before any changes along the lines of Section 470 were contemplated by the Senate.

UNDERMINES TAXPAYER DUE PROCESS

Proponents of the Senate provision have asserted that the provision contained in the Senate version of H.R. 2 would be beneficial to the Internal Revenue Service in litigation efforts against certain U.S. taxpayers involved in certain lease transactions. Ultimately any legal issues surrounding transactions completed prior to the JOBS Act effective date should properly be addressed by the IRS and in the courts on the basis of the laws that were in effect at the time the transactions were entered into. On due process grounds alone, U.S. taxpayers deserve to have their day in court without interference from the Congress before any judgment has been rendered. And to date, there have been no judgments involving such cross border transactions.

Furthermore, nothing in the Senate provision would preclude, nor could a taxpayer expect, that the government would not continue to pursue a case against the

taxpayer, as such cases relate to the tax treatment of past tax years. To reopen such cases would mean that the taxpayer would be subject to double jeopardy.

Adopting legislation that goes back and retroactively changes the law in favor of the government on any provision of law is simply unfair and potentially unconstitutional. The tax system is currently working as intended, with the IRS reviewing facts and circumstances of transactions and challenging taxpayer positions, as warranted. Changing the law and economics midstream creates an unfair bias against taxpayers in favor of the government. If this is allowed, there is no reason Congress could not simply retroactively change the law in favor of the IRS on any issue the IRS is currently challenging in courts or otherwise. That is not the way our U.S. rule of law works, and it is not a change this committee should endorse.

UNINTENDED CONSEQUENCES

We believe that imposing Section 470 retroactively would result in unintended consequences, specifically by retroactively subjecting otherwise common cross-border transactions to a regime designed to address questioned transactions. That is, as drafted, the Senate provision would impose Section 470 on existing transactions never targeted by the proponents. Just as Section 470 has impacted such things as the leasing of medical equipment to non-profit institutions (an otherwise common and efficient practice) on a going forward basis, imposing Section 470 retroactively would cause a number of such previously executed cross border transactions to become uneconomic without cause.

For instance, one of the members of our organization states that the proposed retroactive change to Section 470 would eliminate net deductions for tax years 2007 and beyond on a number of lease transactions entered into years ago (with original equipment cost in excess of $800 million) that the IRS does not consider abusive. Examples include leases entered into during the mid to late 1990's such as rail leases to various European entities and a large lease of manufacturing equipment to a Canadian subsidiary of a U.S. company.

Another member highlights an existing problem with Section 470 that will only be exacerbated by applying it retroactively. Current Section 470's complex loss-trapping rules have inadvertently put not-for-profit hospitals at a competitive disadvantage, as the 9-year class life of medical equipment causes a fixed price purchase option to trigger adverse treatment to the lessor. Accordingly, a not-for-profit hospital must either face a higher lease rate by choosing to have a fixed price purchase option or lose significant flexibility by forgoing a fixed price purchase option. Not only should this existing inequity under Section 470 be fixed to recognize business realities in the area of medical equipment leases, but it should not be imposed retroactively.

Indeed, the leadership of the House Ways and Means Committee and Senate Finance Committee have recognized that as it exists today, Section 470 results in unintended consequences. On December 15, 2005, after the enactment of Section 470 in the JOBS Act, then Chairman Grassley, Senator Baucus, then Chairman Thomas, and Congressman Rangel wrote to then Treasury Secretary Snow and stated that "it has come to our attention that Section 470 may have . . . unintended consequences." "Specifically, Section 470 as currently drafted . . . may apply to certain non-abusive transactions. . . ."

As part of their letter, Senators Grassley and Baucus, and Congressmen Thomas and Rangel requested an extension of transition relief and non-enforcement of Section 470 for certain transactions.

Because of these well-recognized unintended consequences, the Treasury Department has provided relief and non-enforcement of Section 470 for certain transactions in each of the last three (3) years. See, IRS Notice 2005–29 (2005–13 I.R.B. 796), IRS Notice 2006–2 (2006–2 I.R.B. 278), and IRS Notice 2007–4.

In addition, the tax-writing committee staffs and the staffs of the Joint Committee on Taxation and the Treasury Department have been trying to develop legislation that would correct the unintended consequence problems that exist with current Section 470. Just last year, on September 29, 2006, technical corrections legislation was introduced in Congress to address, among other things, the problems of Section 470 having unintended consequences. See, "Tax Technical Corrections Act of 2006." However, to date, those problems still exist.

It seems illogical to now retroactively impose a provision of the tax code that is well-recognized by the tax-writing committees as already having unintended consequences, thereby creating additional confusion and exacerbating IRS compliance and enforcement problems. Moreover, it is irrational to impose it retroactively so as to capture transactions that have never been in question.

CONCLUSION

Mr. Chairman, we believe taxpayers enter into transactions in full reliance on current tax law. This reliance and confidence is the bedrock of the Federal income tax system. Undermining the system by imposing retroactive tax increases is simply unfair as a matter of fundamental tax fairness. Further, it will serve to undermine the confidence of investors to deploy capital, which would devalue any attempt by Congress to use the Code as a means to incent investment.

Accordingly, I urge you and this committee to reject the Senate leasing proposal as part of the minimum wage bill or any other tax legislation. This does not let anyone "off the hook" or absolve any questions of substance, as that process is well underway in the courts, just at Congress intended when it gave the IRS the power to pursue such cases, and just as the Constitution provides for taxpayers to have their day in court.

Thank you for the opportunity to offer our views on this matter and I would be happy to answer any questions you may have.

ATTACHMENT

Effects of Retroactive Application of Section 470 on Financial Statement Earnings and Capital

Summary

The Senate proposal to make Section 470 retroactively applicable to transactions entered into prior to March 12, 2004, coupled with a current change in the GAAP treatment of leveraged leases, could have potentially significant adverse financial statement consequences to many U.S. corporations.

Financial Accounting Treatment of Leveraged Leases

The economic impact of a leveraged lease is determined by its cash flows, including tax payments and refunds, and the associated GAAP financial statement effect is computed under Statement of Financial Accounting Standards No.13 ("SFAS 13"). SFAS 13 employs a two-step methodology under which the internal rate of return ("IRR") derived from cash flows is first determined, followed by application of this IRR to the unamortized investment in the lease. The result is the amount of GAAP financial statement income that is recognized each period. Because incoming cash flows resulting from tax refunds are typically greatest in the early years of a leveraged lease, this methodology has the effect of increasing the IRR, which in turn increases the amount of GAAP financial statement earnings that are recognized. In other words, financial statement earnings are usually the greatest during the early portion of a lease when positive cash flows are at their peak.

Until recently, SFAS 13 did not require a recomputation of GAAP financial statement earnings in situations where the timing of cash flows changed, but the total amount of income recognized over the life of a lease did not change. In other words, a change in the stream of financial statement earnings to be reported over the life of a lease would not change even though the timing of the underlying cash flows was altered.[1]

Subsequent to enactment of IRC Section 470 in 2004, the FASB issued a FASB Staff Position ("FSP") that became effective on January 1, 2007. See, FSP FAS 13–2. In a significant departure from the SFAS 13 approach described above, the FSP provides that changes in the timing of cash flows caused by changes in tax treatment of a leveraged lease will require a recalculation of earnings dating back to the inception of the lease. When such changes in cash flows occur, the revised approach will result in a cumulative adjustment equal to the difference between the amount of GAAP income previously reported and the amount that would have been reported if the change in tax treatment had been known at lease inception. The entire amount of the cumulative adjustment must be reported when a change in tax treatment occurs, which will affect both current period earnings and retained earnings or capital.

Financial Statement Impact of Retroactive Application of Section 470

When IRC Section 470 was enacted it was applicable only to transactions entered into after March 12, 2004. Accordingly, neither SFAS 13 nor the FSP would require any change in the GAAP financial statement treatment with respect to transactions consummated before that date. The Senate has now included a provision in H.R. 2 (the "Small Business and Work Opportunity Act of 2007") that would make IRC Section 470 applicable to all transactions with a foreign entity or person, regardless of

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[1] Such a change if known from inception would have changed the IRR.

when they were entered into. This retroactive change to IRC Section 470 would virtually eliminate the benefit of deductions over the remaining lives of the leases. As a result, future cash flows would be dramatically reduced for a substantial period of time, and the FSP would require recalculation of the IRR from inception of the lease. Since the originally calculated IRR was heavily dependent on *all* future cash flows, not just those already realized, the GAAP financial statement impact on many affected lessors would be severe.

Apart from the negative tax policy considerations of retroactive application of IRC Section 470, the effect on capital markets and the economy, and on financial institutions in particular, would be extremely undesirable. These charges could also reduce retained earnings, and the regulatory capital of affected financial institutions, with potentially severe consequences such as limiting the ability to make loans, pay dividends, violation of debt covenants, rating agency downgrades, and a decrease in share values. Taxpayers clearly never anticipated that the tax law might be retroactively changed in a manner that would lead to such dire consequences.

Chairman RANGEL. I thank the former Member from Texas, and welcome back to the House of Representatives.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman RANGEL. The Chair recognizes Greg Heaslip, from the great State of New York, and the great firm of PepsiCo and its very progressive way in which you are handling the retirement problems of the employees.

We may be calling you back to assist us in giving aid to other multi-nationals to see how we can best protect our employees. Welcome to the Committee on Ways and Means.

STATEMENT OF GREG HEASLIP, VICE PRESIDENT, BENEFITS, PEPSICO, INC., PURCHASE, NEW YORK

Mr. HEASLIP. Thank you, Chairman Rangel, Ranking Member McCrery, and Members of the Committee, for the opportunity to discuss executive compensation proposals contained in the Senate's Small Business Work Opportunity Act of 2007.

PepsiCo is a leader in the food and beverage industry. We employ over 155,000 people, worldwide, 60,000 in the United States in over 400 locations. Our employees are in every congressional district in America, and I hope you are familiar with some of our brands, which include PepsiCola, Frito-Lay, Quaker Oats, Gatoraid, and Tropicana.

At PepsiCo, we are proud of our overall approach to employee compensation and benefits, including our practices in the area of retirement plans and savings. We offer a variety of broad-based programs to ensure that employees who spend a career with our company and perform consistently well can retire with secure lifetime income.

These programs include a traditional defined benefit plan, which is well funded, and a 401(k) plan with a company match that increases with tenure. In combination, these programs achieve our goal of providing retirement security of 70 to 80 percent of pre-retirement income to career employees.

Now, as big as these programs are, a challenge facing many of our employees is that as their earnings increase, qualified plans and Social Security replace less and less of their pre-retirement income. This is due to internal revenue code limits on qualified plan benefits, and limits on Social Security benefits.

Consequently, non-qualified plans and personal savings play a more and more important role in achieving retirement security, as earnings increase. In response to these challenges, PepsiCo has instituted non-qualified savings and retirement programs, which are subject to internal revenue code section 409A. These plans restore benefits to employees affected by qualified plan limits, and encourage employees to save for retirement.

While it appears that the Senate bill is aimed at top executives, its applicability goes far beyond. At PepsiCo, the bill would impact over 1,000 employees, and the individual impacts would be harsh and inequitable. At the same time, we see little benefit to shareholders or to the Government, from a revenue perspective. Allow me to provide three specific examples of the problems the Senate provisions—proposals—would create.

The first is with respect to a restoration plan for defined benefits. PepsiCo sponsors a non-qualified restoration plan that mirrors its qualified pension plan. It is designed to treat employees equitably by restoring benefits that are lost due to qualified plan limits. In our qualified pension plan, as in many traditional defined benefit plans, the value of an employee's pension increases significantly when they become eligible for early retirement.

At PepsiCo, this step up in benefit value generally occurs at age 55. The same feature is mirrored in our non-qualified plan. The Senate's proposal would include the benefit accrual and a non-qualified plan against a deferral cap equal to one times pay—the lower of one times pay or $1 million.

To assess the impact of this on employees, we measured the size of the age 55 accrual for 1,000 plan participants. We were startled to learn that in almost every situation, over 90 percent of the time, the age 55 accrual exceeded the one times pay cap.

As a result, under the Senate's approach, the employee would be taxed on the value of all accruals in all non-qualified plans, and pay a 20 percent penalty, even though he or she is not retiring, or in constructive receipt of the money.

This result would create the unfortunate effect of forcing the company to limit, or eliminate, non-qualified restoration—its non-qualified restoration plan. Clearly, this would cause a significant loss of retirement security for a sizeable group of middle and senior managers, and prevent them from receiving the same level of benefits that other employees are entitled to.

An additional concern is the broader effect this could have on the retirement security of all employees. In today's environment, traditional defined benefit plans already face many challenges. Disenfranchising middle and senior managers from these plans would add another huge challenge to the continuation of these plans. At a time when we're fighting desperately to maintain the defined benefit pension system, it is hard to imagine that this is what the Senate intended with this provision.

PepsiCo offers the opportunity to elect to defer base salary or bonus as a means of encouraging personal and retirement savings. Under the Senate bill, investment earnings on non-qualified deferrals would count against the cap, and could trigger non-compliance, either in isolation or in combination with other plans. The unpre-

dictable and harsh effect of this can be seen from a simple example.

Consider the example of a 45-year-old employee earning about $200,000, who voluntarily defers 30 percent of salary each year. Assume the account earns 7 percent interest, based on market performance. The account generally increases in value, due to the continued annual deferrals and steady investment returns.

As the employee's account balance increases, however, it becomes more likely that 1 year of unexpected high investment returns, combined with accruals from other plans, would throw the employee over the deferral cap. In our example, 1 year of 12 percent returns for a 61-year-old would throw them over the cap, trigger taxes, and trigger penalties, again, even though they're not in receipt of the money, and they haven't retired.

I have other examples that I would like to share with the Committee, but let me suggest that before we issue any 409A regulations, or expand upon it, we should finalize the current regulations that are issued but don't have final guidance available.

If further regulations are deemed necessary, I would encourage that we focus on Chief Executive Officers (CEOs) or National Exchange Officers (NEOs), which is where the perceived abuses have been identified, implement a uniform cap of $1 million or more with annual indexation—in other words, eliminate the "lesser of" test—exclude broad-based restoration plans that don't provide extra benefits, exclude elective deferral programs and the investment earnings on those programs, and, if implemented, make any changes prospective, without the need to modify or review current year deferral elections.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Heaslip follows:]

Statement of Greg Heaslip, Vice President—Benefits, PespsiCo, Inc., Purchase, New York

Chairman Rangel, Ranking Member McCrery and members of the Committee, thank you for the opportunity to discuss the executive compensation provisions in the Senate "Small Business Work Opportunity Act of 2007."

PepsiCo is a world leader in the food and beverage industry and is headquartered in Chairman Rangel's great state of New York. PepsiCo employees 155,000 people worldwide with 60,000 employees in the United States at over 400 locations. In fact, we have employees in every congressional district in America. I am sure you know and enjoy our great company by its brands: Frito-Lay, Pepsi-Cola, Gatorade, Quaker Oats and Tropicana.

As Vice President of Benefits for PepsiCo, let me begin by stating that I share your belief that corporate America has a responsibility to ensure executive compensation is consistent with company performance and in line with shareholder interests. I applaud your efforts to call attention to the vital issues raised by the Senate bill and for providing an appropriate forum to discuss this important topic. At the core, these issues have a direct impact on retirement security and personal savings for millions of Americans, global competitiveness, shareholder interests and tax policy. Any changes to the law in this area should not be taken lightly and should be thoroughly vetted and considered before moving forward. Your commitment to a deliberative process should be commended and I look forward to working with you to arrive at the right public policy outcome.

At PepsiCo we are proud of our overall approach to employee compensation and benefits, including our practices in the area of savings and retirement benefits. We offer a variety of broad-based programs designed to provide retirement security to all employees who spend their career with the company and consistently perform well. These programs include a traditional defined benefit pension plan (which is fully funded) and a 401(k) plan with a company match that increases with tenure. We supplement these programs with an investment in ongoing employee commu-

nications about the importance of savings, pre-retirement planning seminars and personalized planning tools.

In combination, these programs achieve our goal of providing retirement security to career employees by replacing 70 to 80 percent of their pre-retirement income through a combination of company-sponsored programs, Social Security and personal savings.

As good as these plans are, however, a challenge many of our employees face is that, as earnings increase, qualified plans and Social Security replace less of the employee's pre-retirement income. This is due to Internal Revenue Code limits on qualified plan benefits and limits on Social Security benefits. Consequently, non-qualified plans and personal savings play a larger role in achieving retirement security as earnings increase.

In response to these challenges and in order to enable all employees to meet their retirement savings target, PepsiCo has instituted non-qualified savings and retirement programs, which are subject to Internal Revenue Code Section 409A. These programs apply to a large group of middle and senior level managers. They restore benefits to employees affected by qualified plan limits and encourage employees to save for retirement.

The non-qualified "pension restoration plan" currently applies to approximately 900 senior managers whose benefits are subject to qualified plan limits. The restoration plan is mandatory and does not provide executives with "extra benefits." It merely seeks to "keep them whole" with respect to the benefits other employees are entitled to (and which they would receive were it not for the qualified plan limits). Because the primary objective of the plan is to provide retirement benefits, employees do not have any ability to take benefits under the restoration plan in current cash.

In addition we provide an opportunity for approximately 1,000 middle and senior managers to save for retirement by voluntarily deferring a portion of their pay into a non-qualified deferral plan. These voluntary deferrals are not matched. Investment of the deferrals is participant-directed. Investment options essentially match those offered in the 401(k) plan; there are no "above-market" investment options offered.

These programs are not just for the CEO and Named Executive Officers. They are unfunded, meaning the benefits are at risk. In addition, because they are non-qualified, no company deduction is taken until the employee is taxed on their money. The plans are subject to existing 409A requirements on the timing of elections and payouts, the form of payout and the treatment of key employees. In fact, we are still awaiting final regulations on the sweeping 409A reforms enacted by Congress in 2005.

While it appears the Senate bill is aimed at the compensation packages of top executives, its scope and applicability go far beyond and have the potential for tremendous negative impact. At PepsiCo, the bill would impact over a thousand employees who participate in the programs outlined above, and the individual impacts would be harsh and inequitable. At the same time we see little or no benefit to shareholders or to government revenue from the proposal. Following are some specific examples of how the Senate non-qualified deferred compensation provision would turn employee-friendly programs into a nightmare for over a thousand of PepsiCo's employees.

Traditional Defined Benefit Restoration Plan

PepsiCo's non-qualified restoration plan mirrors its qualified plan. It is designed to treat employees equitably by restoring benefits from the pension plan that are lost due to qualified plan limits. As indicated above, the restoration plan does not provide extra or supplemental benefits. It is designed to keep employees whole with respect to the benefits obtainable within the company's broad-based plan.

In PepsiCo's qualified pension plan, as in many traditional defined benefit plans, the value of an employee's pension benefit increases significantly when they become eligible for early retirement. At PepsiCo this "step up" in benefit value generally occurs at age 55, with 10 or more years of service. The same feature is mirrored in the non-qualified plan.

The Senate's NQDC proposal would include the benefit accrual in a non-qualified pension plan against the deferral cap of the lower of 1x pay or $1,000,000. To assess the impact of this, we measured the size of the age 55 accrual for nearly 1,000 employees who participate in PepsiCo's non-qualified restoration plan. We were startled to learn that in virtually all situations (90%+ of the time), the age 55 benefit accrual exceeded the 1x pay cap. As a result, under the Senate's approach the employee would be taxed on the value of all accruals in all non-qualified plans and pay

a 20 percent penalty even though he/she is not retiring or in constructive receipt of the money.

This result would create the unfortunate effect of forcing the Company to limit or eliminate the non-qualified restoration plan. Clearly, this would cause a significant loss of retirement security for a sizable group of middle and senior managers, and prevent them from receiving the same level of benefits other employees are entitled to.

An additional concern is the broader effect this could have on the retirement security of all employees. In today's environment, traditional defined benefit plans already face many challenges. Disenfranchising middle and senior managers from these plans would add another huge challenge to the continuation of these plans. At a time when we are fighting desperately to maintain the defined benefit pension system, it is hard to imagine that this is what the Senate intended with its provision.

Voluntary Deferral Plan

PepsiCo offers eligible employees the opportunity to elect to defer base salary or bonus payments as a means of encouraging personal and retirement savings. As mentioned above, the plan is subject to 409A, the employee directs how the money is invested and there are no "above-market" investment options or company matching contributions.

Under the Senate bill, investment earnings on non-qualified deferrals would count against the proposed annual cap and could trigger non-compliance in isolation or in combination with accruals under other plans. The unpredictable and harsh effect of this can be seen from a simple example.

Consider the example of a 45-year-old employee at a salary of $207,000 who voluntarily defers 30 percent of salary each year (typical among our plan participants). Assume the account earns 7 percent investment return each year based on market performance. The account gradually increases in value due to continued annual deferrals and steady investment returns. As the employee's account balance increases, however, it becomes more likely that one year of higher-than-expected investment returns, combined with accruals in other plans, will throw the employee over the deferral cap. In our example, one year of 12% market returns when the employee is age 61, combined with accruals from other programs, would throw him over the 1x cap.

As a result, the employee would be taxed on the value of all accruals in all non-qualified plans and pay a 20 percent penalty even though he did not access the deferred funds and the funds are still at risk. This draconian penalty is triggered by disciplined saving over time coupled with one year of high market returns and is most likely to happen to long service employees as they are nearing retirement. This does not seem to be the type of behavior we should be punishing with the tax code.

One potentially perverse outcome of this scenario is that triggering taxes and severe penalties on an employee who has not received the money could cause the employee to leave the company so that he would receive the funds and have the cash to pay the taxes and penalties. Public policy should help us retain our workers, not drive them away.

In addition to the examples above, there are other situations in which the Senate's proposal could produce broad, harsh and undesirable outcomes.

Severed Employees

Unfortunately, the Senate non-qualified deferred compensation proposal does not make a distinction between CEOs who are terminated for poor performance and other employees who lose their jobs for reasons beyond their control and receive economic consideration.

It is occasionally necessary through corporate restructuring and/or reorganization to close plants or other facilities. When this occurs at PepsiCo, the company often provides employees who are within five years of retirement with a special retirement benefit that exceeds the value of what they would otherwise be entitled to as a terminated employee. The special retirement benefit equals what they would have received if they had been eligible for retirement when the facility was closed.

As an example, take the case where Frito-Lay closes one of its manufacturing plants. Consider a plant manager who is 53 years old (2 years from retirement eligibility), makes $100,000 and is losing his job because of the plant closing. Because the employee is close to retirement and his job is being eliminated, the Company provides a special early retirement benefit as part of the employee's severance. The benefit is paid from the non-qualified pension plan in order to comply with qualified plan non-discrimination rules. In this case, the employee could hit the cap in the year he was severed due to job elimination as the value of the non-qualified sever-

ance benefit is greater than 1x pay. The employee would be taxed on the value of his special early retirement benefit and pay a 20 percent penalty at a time when he has lost his job and is entering retirement or a financially uncertain time.

This is a circumstance that reaches deep into the rank-and-file at PepsiCo—it could affect any employee who makes $100,000 or more and is close to retirement—that we would hope Congress would avoid.

Retention Bonus

In order to maintain an alignment of interests and retain employees, particularly those at the executive level who have advanced career experience, PepsiCo has a mandatory bonus deferral program. Under the terms of the mandatory bonus deferral, a portion of an executive's annual bonus is deferred for three years. The executive must remain with the Company for the deferral period in order to receive their deferred bonus. This is an essential tool for encouraging and rewarding tenure. These bonuses are taxable when they are received at the end of deferral period and the employee has no ability to control the bonus amount or timing of this event.

If arrangements such as this were subject to the deferral cap, companies would have to consider replacing employee retention features with current year compensation. From a shareholder perspective the Senate-passed legislation would be counterproductive in that it would likely result in this type of change.

Grandfathering and Transition

In reviewing the Senate executive compensation provisions, it is extremely troubling that the effect of the provisions is to apply new rules retroactively. As someone who must confront the challenge of helping employees plan for retirement in a way that complies with an increasingly complex thicket of regulations, I would emphasize that certainty is essential. Plan sponsors and individual employees are already challenged with making significant financial decisions in the face of incomplete guidance. In the case of non-qualified deferred compensation, the recent changes to 409A impose strict new penalties and require that binding elections be made well in advance of actual deferrals. The Senate approach changes the rules after the fact and has put employees and employers in a bind. There is no correction option under 409A and, in fact, we still do not have final regulations on how to interpret a law that was enacted two years ago. The Senate bill creates many new headaches by ignoring the mechanics of how 409A is being implemented.

Given the severity of penalties for non-compliance, it is likely we will need to modify existing non-qualified deferred compensation plans to meet the requirements of any change in law. To do so in the right fashion, we must have an opportunity to transition to the new rules in the least disruptive manner. In the absence of an actual change in law, we also need to be able to move forward with the election and deferral decisions that are locked in place and moving forward as we speak. Grandfathering money that has already been deferred is a matter of fairness and providing adequate transition relief will ensure that employee attempts to save are not inappropriately and unfairly undermined. I applaud and appreciate the Chairman and Ranking Member for their unified opposition to retroactive changes in the law.

162(m)

The "Small Business Work Opportunity Act of 2007" also contains a provision that would modify the definition of "covered employee" for purposes of the deductibility of executive compensation. While PepsiCo is not directly impacted by this provision, I think it is important to make a few comments. First, the same principle of opposing retroactivity applies here. To the extent employment agreements and compensation decisions were based on current law and executed as such, it is very troubling that Congress would even consider changing the law and applying it retroactively. This sort of action undermines taxpayer confidence and makes it exceedingly difficult to set compensation and benefit policy at a company. The original 162(m) legislation contained an explicit grandfather of binding contracts and arrangements. This approach should be maintained. There is also an effort to extend the "covered employee" group beyond the current SEC definition. While this does not seem to be problematic at face value, I would caution that it adds complexity. To the extent we can unify the rules and speak in consistent terms, it makes for a more coherent and easily identifiable policy. It seems logical that the tax code and the SEC should be able to agree on who constitutes the "covered employee" group.

Constructive Reforms

Based on a critical analysis, the nature and scope of the Senate bill gives rise to myriad issues that should be resolved prior to determining the need to act. Given the potential impact on retirement security, personal savings, competitiveness and

shareholder interests, I would hope that Congress will proceed with great caution and restraint. The issues are too important to not get this right.

Prior to any new legislation, we would like to see final guidance on current 409A regulations. The impact of the recently enacted sweeping new reforms of 409A is still being absorbed by most companies. Enacting new changes before we know how the current rules work seems premature. However, if expansion of the rules governing non-qualified deferred compensation is necessary for political or substantive reasons, we recommend a more focused approach:

- Issue final guidance on current 409A regulations before expanding 409A's application to deferred compensation
- If further regulations are necessary:
  - Focus on CEOs or NEOs, where perceived issues have been identified, rather than a broad slice of employee population
  - Implement a uniform cap ($1 million or more) with annual indexation (i.e., eliminate the "lesser of" test)
  - Exclude broad-based pension restoration plans that offset limits in the qualified pension plan and do not provide "extra" benefits
  - Exclude elective deferral programs and the earnings on account balances so long as these earnings are market-based
  - Exclude mandatory bonus deferrals
  - If implemented, make any changes prospective, without the need to review and modify current year deferral elections
  - Provide for a "correction" mechanism to allow for plan participants who run afoul of 409A to comply without triggering penalties

PepsiCo is committed to being a world leader in corporate governance. We take very seriously our responsibilities to our employees, shareholders and customers. I appreciate the opportunity to share our view of the Senate executive compensation proposals and your willingness to consider them in an open venue with a healthy public discourse. Most importantly, we look forward to working with you to arrive at the appropriate public policy. I would be happy to discuss any of these issues with you or answer any questions. Thank you.

Chairman RANGEL. Thank you.

The Chair recognizes Kenneth Petrini, vice president of taxes, Air Products and Chemicals, Inc.

STATEMENT OF KENNETH R. PETRINI, VICE PRESIDENT, TAXES, AIR PRODUCTS AND CHEMICALS, INC., ALLENTOWN, PENNSYLVANIA, ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. PETRINI. Mr. Chairman and Members of the Committee, thank you for inviting me to testify on behalf of the National Association of Manufacturers (NAM), on the revenue-raising provisions included in the legislation currently pending in Congress. My name is Ken Petrini, and I am vice president of taxes at Air Products and Chemicals. I also serve as the Chair of the tax and budget policy Committee of NAM.

The NAM is the Nation's largest industrial trade association, representing small and large manufacturers in every industrial sector, and in all 50 States. Many NAM members believe that tax relief is critical to economic growth and job creation. In contrast, revenue raisers, like those that we will talk about in our testimony, will impose new taxes on those businesses, making it more difficult for them to compete in the global marketplace.

In particular, H.R. 2, as passed by the Senate, includes several tax increases that are of particular concern to American manufacturers. A common theme with these proposed changes is that while they may be rooted in some valid policy concerns, they are drafted

in such a way to be overly broad, and threaten to ensnare transactions and expenses well beyond their intended scope.

Manufacturers currently face some of the highest legal costs in the world. Based on a recent study by NAM's Manufacturing Institute, court costs for U.S. businesses are at historical highs, and are higher than similar legal costs in other countries. Yet, two provisions in the Senate bill would add to the current anti-competitive legal cost burden facing U.S. manufacturers.

The proposals to eliminate tax deductions for punitive damages and settlements of potential violations of law represent significant changes to, and an unnecessary expansion of, current law that will increase the cost of doing business in the United States for manufacturers.

Under current law, taxpayers generally can deduct damages paid or incurred, as a result of carrying out a trade or business, regardless of whether those damages are compensatory or punitive. The proposed change to make punitive damages—damage payments in civil suits non-deductible, whether made in satisfaction of a judgement or settlement of a claim, runs counter to fundamental and well-established tax principles, and represents unsound public policy.

In particular, the proposal violates the principle that income should be taxed only once. Since punitive damages would not be excluded from income, both the payor and the recipient would be subject to tax on the punitive damages, thus imposing a double tax on the same income.

The proposal also violates another principle of Federal tax policy, and that is to provide similar tax treatment for similar behavior. Different standards and guidelines apply in different jurisdictions in this country, and that could result in punitive damages in one jurisdiction that are not punitive damages in another.

For a broader policy perspective, the proposal is based on a false premise that punitive damages are the same as non-deductible criminal or civil fines that are fixed in amount, and are imposed for specific activities that are defined in advance. In contrast, punitive damages are often awarded under vague and unpredictable standards.

Clearly, too, the issue of settlement agreements with governments, as in the proposal discussed earlier, this provision runs counter to fundamental and well-established tax principles, and represents unsound public policy. Currently, a business cannot deduct from income any fine or similar penalty paid to a government for violation of any law.

This proposal would extend this provision to the non-penalty portion of settlement payments, thus eliminating the deduction for most, if not all, settlement agreements with the government on a wide range of issues, regardless of whether there was any wrongdoing. We are concerned that, regardless of the intended scope of the provision, that it could be greatly expanded in subsequent administration by tax auditors to deny deductions and to prevent resolutions of many issues that can be beneficial to all.

Manufacturers operating in the United States today face a significant regulatory burden. These regulations are often ambiguous, and subject to interpretation, making it difficult, if not impossible,

to ensure 100 percent compliance at all times. We have a strong policy reason to have a system that allows businesses to voluntarily settle and pay Government claims.

NAM, also in its testimony—and in the interest of time, I will try to summarize very briefly—has expressed concern about the non-qualified deferred compensation provisions, and also section 162(M) of the proposals dealing with executive compensation. We agree with the comments of the prior witness, and we would only add that, with respect to deferred compensation, that we ask the Committee to consider the policy reasons behind the deferral of compensation, and the reasons why businesses actually allow for deferred compensation, and also to consider that in enacting section 409A in 2004, you enacted provisions that would make it very difficult for senior executives, key employees, to cash out of a business while it was failing.

Those provisions are, in fact, consistent with the policy behind deferred compensation, which seeks to align the interests of the shareholders with those of the executive, and we should be encouraging the deferral of compensation, in an unfunded fashion, by executives, because it does, in fact, align those interests with those of the shareholders. Thank you again for this opportunity to testify.

[The prepared statement of Mr. Petrini follows:]

Statement of Kenneth R. Petrini, Vice President—Taxes, Air Products and Chemicals, Inc., Allentown, Pennsylvania, on behalf of the National Association of Manufacturers

Mr. Chairman and Members of the Committee,

I am pleased to have the opportunity to testify this morning on behalf of the National Association of Manufacturers (NAM) on several revenue raising provisions included in legislation currently pending in Congress. We applaud the Committee's initiative in holding the hearing.

My name is Ken Petrini and I am Vice President, Taxes at Air Products and Chemicals, Inc., in Allentown, Pennsylvania. I also serve as the Chairman of the NAM's Tax and Budget Policy Committee. The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. NAM members believe strongly that tax relief is critical to durable economic growth and job creation. In contrast, revenue raisers—like those I will describe in my testimony—would impose new taxes on many businesses, making it more difficult for them to compete in the global marketplace.

In particular, the Small Business and Work Opportunity Act of 2007 (H.R. 2) as amended by the Senate on February 1, 2007,[1] includes several tax increases that are of particular concern to American manufacturers. These include proposals to:

- **Deny Deductions for Punitive Damage Payments;**[2]
- **Deny Deductions for Settlement Payments;**[3]
- **Limit Deferrals Under Nonqualified Deferred Compensation Plans;**[4]
- **Expand the Definition of Employees Subject to Rules Limiting the Deduction for Salary Payments;**[5] **and**
- **Impose New Taxes on Expatriates.**[6]

A common theme with these changes is that, while they may be rooted in some valid policy concerns, they are drafted in such a way to be overly broad and threaten to ensnare transactions and expenses well beyond their intended scope.

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[1] Fair Minimum Wage Act of 2007 [H.R. 2 EAS/17], as passed by the Senate, 2/1/07
[2] Ibid, Section 223
[3] Ibid, Section 224
[4] Ibid, Section 226
[5] Ibid, Section 234
[6] Ibid, Section 225

Increasing Legal Costs for American Manufacturers

Manufacturers currently face some of the highest legal costs in the world. Based on a recent study by NAM's research and education arm, the Manufacturing Institute, tort costs for U.S. businesses are at historical highs and are higher than similar legal costs in other countries.[7] Moreover, the tort burden on manufacturers (as a percentage of manufacturing output) is roughly 2.2 times larger than the burden of these costs on other sectors of the economy.[8]

Two provisions in the Senate-passed version of H.R. 2, if enacted, would add to the current, anti-competitive legal cost burden facing U.S. manufacturers. Specifically, the proposals to eliminate tax deductions for punitive damages and settlements of potential violations of law represent significant changes to, and unnecessary expansion of, current law that will increase the cost of doing business in the United States for manufacturers.

Punitive Damages

Under current law, taxpayers generally can deduct damages paid or incurred as a result of carrying on a trade or business, regardless of whether the damages are compensatory or punitive. The proposed change to make punitive damage payments in civil suits non-deductible, whether made in satisfaction of a judgment or in settlement of a claim, runs counter to fundamental and well-established tax principles, and represents unsound public policy.

From a tax policy perspective, the proposal represents a sharp departure from the income tax principle that taxpayers should be taxed on net income. To measure net income accurately, all expenses associated with the production of income are properly deductible.

Similarly, the proposal violates the principle that income should be taxed only once. Since punitive damage awards would not be excluded from income, both the payor *and* the recipient would be subject to tax on the punitive damages, thus imposing a "double tax" on the same income. The United States Treasury would get a windfall, but businesses would receive a "tax penalty."

The proposal also represents a departure from another objective of federal tax policy—to provide similar tax treatment for similar behavior. Because of different standards and guidelines in the current civil justice system, conduct that results in punitive damages in one state may not result in punitive damages in another. For example, standards for awarding punitive damages vary widely among states—a number of states have "caps" on punitive damages and some states do not allow punitive damage awards at all.

NAM also is concerned about significant tax administration issues under the proposal. Under current law, it is often difficult to determine the character of awards (i.e., compensatory vs. punitive), particularly in cases that are settled in a lump sum while on appeal. The term "punitive" is not defined in the tax code or regulations nor is the term defined in the proposal. The Tax Court has held that state law determines whether awards are punitive or compensatory in nature, which suggests that the proposal could result in dramatically different treatment of otherwise similarly situated taxpayers in different locales.

Moreover, one jury may award damages while another may decide there is no liability even where the facts are very similar. A prime example is *BMW of North America v. Gore.*[9] In this case, a jury awarded the plaintiff $4 million in punitive damages because BMW had sold as new a car that had received touch up paint treatment. In contrast, a few months earlier, another jury in the same county in a case with the same defendant and nearly identical facts found no liability.

Another area of concern for NAM members is the effective date of the proposal. Disallowing deductions for amounts paid or incurred on or after the date of enactment would *interfere with a taxpayer's decision today whether to appeal an initial award of punitive damages. Because the deduction would continue to be available only for amounts paid before the enactment date, taxpayers recently hit with initial damages awards would be discouraged from exercising their right to appeal. Moreover, existing damage award amounts have been based on the assumption that such amounts would be deductible. Disallowing deductions for these existing awards would impose a far greater penalty on taxpayers than was intended by judges and juries.*

From a broader public policy perspective, the proposal is based on the false premise that punitive damages are the same as non-deductible criminal or civil fines. Criminal or civil fines are fixed in amount and are imposed for specific activi-

[7] "The Escalating Cost Crisis," p. 11 The Manufacturing Institute, 2006.
[8] Ibid
[9] 517 U.S. 559

ties that are defined in advance. In addition, criminal liability must be proven "beyond a reasonable doubt," i.e., the jury must be virtually certain of its decision. In contrast, punitive damages are awarded after the fact under vague and unpredictable standards such as "reckless" or "wanton" or "gross negligence" or all three.

Settlement Payments

NAM members also have significant concerns about the impact of the proposal that would prevent companies from deducting the cost of settlement agreements with the government. Like the proposal discussed earlier, this provision runs counter to fundamental and well-established tax principles, and represents unsound public policy.

Under current law, a business cannot deduct from income "any fine or similar penalty paid to a government for the violation of any law." The proposal would significantly extend this provision to the non-penalty portion of settlement payments, thus eliminating deductions for most, if not all, settlement agreements with the government on a wide range of issues, regardless of whether there was any wrongdoing.

NAM members believe that the language as drafted would sweep in a large number of unintended and legitimate expenses. In particular, the "inquiry into the potential violation of any law" clause included in the proposal could be read to include almost all payments made by a business in connection with daily, routine interaction with government agencies. By eliminating a deduction for an ordinary and necessary business expense, the proposal represents a dramatic change in longstanding tax policy that would act as a disincentive for companies to enter into these agreements.

Manufacturers operating today in the United States face a significant regulatory burden. In many cases, these regulations are ambiguous and subject to interpretation making it difficult, if not impossible, to ensure 100 percent compliance at all times. Consequently, there is a strong public policy reason to have a system that allows businesses to voluntarily settle and pay government claims.

Moreover, current law establishes a distinction between punitive and nonpunitive payments that has a long history in the courts and with the Internal Revenue Service.[10] According to IRS officials, the IRS is committing "significant resources" to ensure the proper treatment of settlement payments.[11] In contrast, the proposed change would replace this well-established and workable precedent with a new, all-encompassing standard with which the courts and the IRS would have to struggle. The approach taken by the proposal is to disallow a broad category of deductions (legitimate and otherwise), and require taxpayers to rely on limited exception language to claim clearly proper deductions. Ironically, the need to fit oneself into the narrow scope of the exception would limit some of the flexibility that exists today in responding to real or perceived violations of laws and regulations and would limit the ability of business and government to agree on certain remedies that benefit society.

Clearly, American consumers and businesses would lose if the proposals on punitive damages and settlements were adopted. U.S. manufacturers face significant government regulation and operate in a world where no product is or can be absolutely perfect. These proposals would hamper entrepreneurship, innovation, and product development by further adding to the cost of doing business. This, in turn, would increase the price of goods and services for consumers, chill innovation, put jobs at risk and undermine U.S. competitiveness.

Unwarranted Attacks on Benefits and Compensation

Nonqualified Deferred Compensation

NAM members strongly oppose a provision in the Senate-passed version of H.R. 2 that would impose significant limitations on nonqualified deferred compensation plans. The proposal, which is not targeted at any abuse of deferred compensation rules, is a solution in search of a problem that would effectively eliminate the ability of employers to use deferred compensation as a retention tool for valued employees.

In 2004, Congress adopted significant changes to nonqualified deferred compensation laws that were designed to address perceived abuses. The legislation—the American Jobs Creation Act of 2004[12]—created a new tax code section (Section

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[10] *See Talley Inds., Inc. v. Commissioner,* 116 F.3d 382 (9th Cir. 1997); *Middle Atlantic Distributors, Inc. v. Commissioner,* 72 T.C. 1136 (1979); *see also* Field Serv. Adv. 200210011 (Nov. 19, 2001).

[11] Letter to Sen. Charles Grassley from B. John Williams, Jr. Chief Counsel, Internal Revenue Service 4/1/03

[12] P.L. 108–357

409A) that significantly reformed existing rules for the establishment and operation of nonqualified deferral arrangements.

In particular, Section 409A was designed to address perceived abuses of nonqualified deferred compensation plans, principally whether the individual making the deferral had control of the deferred assets. Under 409A, amounts deferred under nonqualified arrangements must remain at a substantial risk of forfeiture to the employee. Final regulations to implement Section 409A (which are expected to run to hundreds of pages) have yet to be finalized by the Treasury Department. NAM members believe that Congress should allow the new law to work before considering additional changes.

In contrast, the proposal included in the Senate bill would further restrict the rules on nonqualified plans by limiting annual deferrals to the lesser of the five-year average of an individual's taxable compensation or $1 million. The legislative history of the provision [13] makes clear that earnings inside a deferred compensation plan should be counted towards the annual cap on deferrals. As a result, violations of the new rule could occur merely as the result of the passage of time and not as a result of any action by the employee or the company. The potential penalties are severe. An individual who intentionally or unintentionally violates the provision would be subject to immediate taxation on the entire deferred balance plus an additional 20 percent excise tax.

Although tax avoidance on deferred amounts is cited as the primary reason behind the proposal,[14] there is no avoidance of taxation under a nonqualified deferred compensation plan. Rather, tax is deferred until a future period. There is no tax consequence to deferrals into nonqualified plans because the matching principle applies, i.e., a deduction is only taken by the employer when the deferred amounts are actually received by the employee and taken into income. Furthermore, though we believe the proposal is aimed at large deferrals (although as explained later, it does not just pertain to large deferrals), it is unlikely that there will be a significant benefit from lower tax brackets when amounts are paid out. Since employment taxes will typically be paid at deferral or when the amounts are no longer subject to forfeiture, there simply is no tax avoidance in play.

Nonqualified deferred compensation arrangements are used by many manufacturers to motivate and reward their workforce and to align the interests of employees with the interests of the company. Sometimes these plans are non-elective restoration plans, effectively restoring benefits to individuals that have been eliminated from tax qualified plans because of income limits. In other cases, these plans are used as supplemental retirement plans or incentive plans.[15] Still, in other cases, the decision to defer is a voluntary one, made by the employee under the rules of Section 409A. The Senate proposal 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. By voluntarily deferring compensation into a nonqualified plan, the employee gives up the right to receive that compensation and puts its eventual payment at the risk of the future performance of the company. If the plan offers the chance to invest the deferred funds in company stock, the alignment is even stronger. These arrangements should be encouraged, not restricted. The legislation enacted in 2004 adds safeguards to prevent employees from taking the deferred money and running when times are bad. As a result, employees who defer compensation know that if the company fails, it is unlikely they will ever receive those funds. This is a powerful corporate governance tool that aligns the interests of executives and shareholders.

The proposed limits on nonqualified deferred compensation also would have unintended consequences when applied to a typical supplemental pension plan that pays annual lifetime benefits in retirement. In many cases, the vesting of these benefits in a single year could push an employee's deferred compensation above the provision's annual cap, leaving the employee liable for an immediate tax and penalty on amounts they will receive over their lifetime. For example, the present value of a modest lifetime annuity payable at retirement could easily exceed the cap since the payment is assumed to continue as long as the retired employee lives. To avoid this problem, employers would have to pay the discounted value of the pension as a lump sum. Forcing lump sum payments would be bad pension policy and would re-

[13] Senate Report 110–1, p.52

[14] Ibid

[15] Examples of affected plans are included in Attachment A and specific employee examples are included in Attachment B.

move a significant corporate governance benefit that is achieved when an employee is tied to the company for life.

It also is important to note that because the proposal would apply to amounts that exceed the lesser of the five-year average of an individual's taxable compensation or $1 million, it 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. Furthermore, the proposed limit on annual deferrals would act as a highly intrusive tax penalty on a company's fundamental business decision to pay employees through deferred rather than current compensation.

New Limits on Deducting Salary Payments

NAM members also have serious concerns about a provision in the Senate bill that would expand the definition of a covered employee under Section 162(m) of the tax code, which limits the deduction of salary payments. In recent years, the Joint Committee on Taxation[16] as well as a number of public and private sector witnesses before the Senate Finance Committee[17] has criticized this provision. In contrast, the Senate proposal would add a far-reaching new compensation limit to the tax code.

Section 162(m) currently denies an employer a deduction for non-performanced based compensation in excess of $1 million paid to an individual who is a "covered employee" of the employer, i.e., the taxpayer's chief executive officer ("CEO") or one of the four highest paid executive officers of the company at the end of the year (the "Top 4") whose compensation is required to be disclosed under the Securities and Exchange Commission's (SEC) proxy rules.[18]

In addition, the deduction limit applies if the non-performance-based compensation in excess of $1 million is paid to an individual who is a covered employee on the last day of the year in which the payment is made. Therefore, an employer might contractually commit to pay compensation to an employee on separation from service, at which time the employee would not be a "covered employee" under Section 162(m).

The Senate proposal would expand the definition of covered employee under Section 162(m) to include (i) any person who was CEO during any part of any year (not just the end of the year) and (ii) any person who ever was a "covered employee" in any year after 2006 (even if that person is not a covered employee in the year that the compensation payments are received or the year the services are performed). In effect, the proposal creates a new rule that if an employee is ever a covered employee, he will always be a covered employee—even if current compensation eliminated them from the "high five" of a corporation.

Under the proposal, compensation earned or payable in the future to an employee who at any time in a taxable year beginning after December 31, 2006, was a covered employee would remain subject to Section 162(m) in perpetuity. As drafted, this proposal represents a significant expansion of the scope of Section 162(m), rather than an attempt to close an inadvertent loophole.

The Senate proposal also modifies the definition of covered employee by dropping a cross reference to the securities law from existing Section 162(m). The SEC's new proxy rules (which apply to proxies filed for fiscal years ending on or after December 15, 2006), require detailed disclosure for any person who acts as CEO during the fiscal year, any person who acts as CFO during the fiscal year, and the three other most highly compensated executive officers other than the CEO and CFO. In order to retain the previous group for tax purposes (i.e., the CEO and the Top 4), the statutory change to Section 162(m) removes from the definition of "covered employee" a requirement that "the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934." This approach has serious unintended consequences and may significantly and inadvertently expand the category of employees who may be covered.

In addition, as drafted, the proposal would be retroactive, denying corporations' deductions for compensation that was earned before 2007, by any employee who becomes a covered employee after 2006. Many employers today have outstanding compensation obligations that were structured in reliance on current law, but that would become non-deductible under the proposed amendment. Unfortunately, there is little or nothing a corporation could do to protect the deduction it thought it al-

[16] "Present Law and Background Relating to Executive Compensation, " Joint Committee on Taxation, JCX–39–06, 9/5/06

[17] Executive Compensation: Backdating to the Future, 9/6/06

[18] Note that, because the SEC recently amended the proxy disclosure rules to no longer include "the Top 4," Section 162(m) is no longer congruent with the proxy rules. "Executive Compensation and Related Person Disclosure; Final Rule and Proposed Rule" *Federal Register* Vol. 71, No. 174 (8 September 2006): 33–8732A.

ready had—existing contractual arrangements are legally binding on the employer and cannot simply be rewritten by the employer to reflect an unanticipated retroactive change in law.

By denying a deduction for pre-2007 compensation an employer is obligated to pay, the proposal will raise taxes on corporate employers without changing corporate compensation practices. While a retroactive application of the new rule will not affect executives who will be paid what they are owed, corporate shareholders stand to lose because of the corporation's tax increase. Note that this was not the case when Section 162(m) was originally enacted and Congress expressly grandfathered all compensation payable under written binding contracts that were already in effect.

While we oppose enactment of the changes to Section 162(m), if these changes are made they should only apply prospectively since employers cannot control past compensation arrangements. At a minimum, the proposal should expressly provide that amended Section 162(m) will only apply to tax years beginning after the date of enactment and will not apply to any compensation to which an employee had a legally binding right, whether or not contingent, on or before the last day of the taxable year including [the date of enactment] or which relate to services performed before such last day.[19]

The NAM also believes that delinking Section 162(m) from proxy rules is not in the public interest. Current law defines a covered employee by reference to the SEC's proxy rules. This makes sense for two reasons. It is easier for taxpayers (and the IRS) to figure out who is a covered employee in advance of paying compensation. In addition, it targets the rule to *"executive officers"* of a company within the meaning of the Securities Exchange Act, i.e., officers who have policy-making functions and therefore arguably can influence their own compensation.

Based on legislative history,[20] the proposal is intended to "delink" the definition of a "covered employee" from the definition used by the SEC as a result of changes in the SEC's proxy rules. The SEC has recently revised the proxy rules to now cover the CEO, the CFO and the next three most highly compensated employees. The policy reason for "delinking" is not clear. As drafted, the proposal represents a significant expansion of the scope of Section 162(m) to cover employees with no policy-making authority who are not in a position to influence their own compensation and ambiguity as to what compensation counts for determining whether an employee is one of the "Top 4".

The proposal also deletes references in Section 162(m) to "total compensation . . . for the taxable year [that] is required to be reported to shareholders under the Securities Exchange Act of 1934." Accordingly, proposed changes to Section 162(m) could be read to apply to all "officers" of an employer, even those with no policy-making authority. Neither Section 162(m) nor the Senate proposal defines the word "officer," thereby creating ambiguity where none exists today. SEC proxy disclosure is limited to "executive officers," which means those officers who have significant policy-making authority for the issuer. We do not believe that the proposal was intended to broaden the scope of covered employees in this way and urge that, if enacted, Congress clarifies the proposal to state that covered employees continue to include only executive officers for whom proxy disclosure could be required.

In addition, while the proposal provides that the four "highest compensated" officers in the year would be covered, it does not specify a definition of "compensation." Under current law, that answer is well understood by corporations because a "covered employee" is determined by reference to the SEC's proxy rules. New SEC rules capture executive officers' total compensation for each year, including equity awards and deferred compensation, which may not be taxable until several years in the future. By deleting the reference in Section 162(m) to the SEC's proxy rules, the Senate proposal leaves no definition of compensation whatsoever.

In sum, the NAM strongly believes that corporate governance issues—like executive compensation—should be addressed through corporate governance changes, not through the tax code.

New Tax on Ex-Pats

Among the revenue-raisers in the Senate proposal is a little noticed but potentially devastating provision that would change the rules for taxation of foreign persons who are long-term residents of the United States and are leaving the country. The provisions would levy a new "mark-to-market" tax on the unrealized appreciation in all their property, on the day before expatriation. In effect, the expatriate

[19] The effective date of the proposal should permit public companies time to obtain shareholder approval of performance-based plans that may need to be modified.

[20] Senate Report 110–1, p.68

is treated as having "sold" all his or her property, for its fair market value, on the day before expatriation. Property subject to the provision includes personal property, interests in qualified retirement plans, and interests in nonqualified trusts.

This provision could have a significant negative impact on resident aliens employed by U.S. manufacturers. For example, a resident alien who has worked for a U.S. company and decides to return to his or her home country to retire or for other business or personal reasons could find the value of their assets significantly eroded—especially if there is an acceleration of tax payable on 401(K) or other retirement accounts.

Finally, another general concern of NAM members is the inclusion of retroactive tax provisions in the Senate bill as well as other tax legislation. It has long been the position of the NAM that a retroactive imposition of taxes is fundamentally unsound and unfair.

In sum, NAM members believe strongly that tax relief will go a long way to ensuring that our economy keeps growing. Conversely, tax increases, like those outlined above, will negate much of the positive impact of tax relief and, in some cases, threaten continued economic growth. We appreciate the opportunity to present our views on these issues to the committee and we thank you in advance for rejecting these revenue raisers.

Attachment A

Examples of Benefit Plans and Company Types Affected by Section 226

Restricted Stock Units: In recent years, many employers have redesigned their equity programs to increasingly rely on the use of restricted stock units (RSUs). Typically, employees 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. 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. Some RSU programs fit within the regulatory exception from 409A for compensation that is paid upon vesting (or within 2½ months after the year of vesting.) It is not uncommon, however, for employers to find that their RSU program does not meet the short-term deferral exception and that compensation paid under the program is subject to 409A. In some instances, an employee may vest in the RSUs in increments over the performance period but is not paid until full vesting is attained at the end of the performance period. In other instances, an employee may vest fully upon reaching a specified retirement age during the performance period. Under the legislation, such RSU grants would be subject to the one-time pay limit and could cause employees to exceed the limit.

For example, a newly hired employee of a Fortune 500 company receives a grant of RSUs that is subject to 409A. The employee is granted 6,000 RSUs at a time when the value of the company's stock is $30 (i.e., value of the grant is $180,000). The employee is scheduled to vest in ⅕ of the RSUs each year over a 5-year performance period. The employee receives a base salary of $140,000, which under the Senate provision would be the employee's one-time pay limit for the first year. Because the value of the RSU grant exceeds the one-times pay limit, a 409A violation would occur and the employee would be subject to a 20 percent additional tax on the value of the RSUs as they vest (i.e., 20 percent of the RSUs per year) over the 5-year period.

Because "earnings" on the underlying shares of the company's stock also are subject to the limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the RSUs increased beyond the limit.

For example, an employee is granted 1,000 RSUs at the beginning of employment with a technology company. The employee "vests" in these units after 5 years of service and the RSUs are designed to pay out after 10 years. The employer believes that this plan aligns the employee's interest with growing the company value rather than maximizing current salary. At the beginning of employment, the RSUs were valued at $15 per share. The employee earns approximately $100,000 per year and receives modest increases (based on CPI of 3 percent). The employee's 5-year average taxable compensation from the company is $110,000 at the end of year 5. The company stock price stays relatively flat, but in year 6 the company becomes highly successful and the valuation of the stock takes off eventually to exceed 10 times the original price. The one-times-pay limit would be exceeded because the increase in the RSU value in year 6 will exceed $110,000.

Supplemental 401(k) Plans: 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 plan as additional deferrals that count against the one-time pay limit and could cause the employee to exceed the limit.

For example, a Fortune 500 company offers a nonqualified supplemental plan to certain employees, including mid-level management employees receiving approximately $150,000 to $200,000 per year in total wages from the company. Many of these mid-level management employees are long-serving employees who typically defer 20 to 40 percent of their wages. Employees who participate in the plan receive a small matching contribution (typically between $3,000 and $6,000) from the company based on their deferrals. Investment earnings are credited to an employee's bookkeeping account in the plan based upon deemed investments chosen by the employee from among the same mutual funds as those offered in the company's 401(k) plan. Using 2006 data, the company has calculated that at least seven such employees would have exceeded their 5-year average taxable compensation. The following chart summarizes the relevant information:

Emp.	Years of Service	2006 Total Wages	5-year Average Taxable Wages	Account Balance As of 12/29/06	2006 Deferrals And Match	2006 Investment Earnings	Total Deferrals	Deferrals Above 5-year Avg Limit
1	27	$159,500	$ 90,180	$418,400	$ 66,700	$ 72,300	$139,000	$48,820
2	13	$175,400	$102,220	$508,300	$ 60,800	$ 52,500	$113,300	$11,080
3	28	$179,300	$ 62,380	$364,100	$116,400	$ 27,000	$143,400	$81,020
4	25	$178,300	$126,920	$614,700	$ 47,900	$109,100	$157,000	$30,080
5	30	$183,700	$126,040	$617,700	$ 38,000	$141,800	$179,800	$53,760
6	14	$194,400	$128,020	$486,500	$ 62,200	$ 73,200	$135,400	$ 7,380
7	6	$203,000	$ 92,020	$647,100	$ 76,300	$ 94,700	$171,000	$78,980

Since earnings that are tied to a publicly-traded investment are often very unpredictable, employees would have to leave a large cushion below the one-time pay limit to take into account potential earnings. An employee who participates over a number of years could easily exceed the one-time pay limit solely because of earnings.

For example, assume employee 5 in the above example stopped making deferral elections after 2006, and that the employee receives modest increases in wages each year (based on CPI of 3 percent). Also assume that the employee elected to have all of his account balance as of December 29, 2006 ($617,700) be deemed invested in the plan's S&P 500 index fund, and that for the 4-year period from 2007 to 2010 that fund's annual return was 20 percent per year (which would be consistent with the S&P 500's performance in the late 1990s). By 2010, there would be a 409A violation solely because the "earnings" credited to the employee's bookkeeping account ($213,477) exceeded the employee's 5-year average taxable compensation from the company ($189,376).

Supplemental Pension Plans: Some companies maintain supplemental pension programs to serve as retention tools and assist management employees in saving for retirement. 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 incent employees to stay in their jobs. The legislation would require employers to change or abandon these arrangements because later-year accruals may exceed the one-time pay limit 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 pension 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-time pay limit to be exceeded.

For example, one Fortune 500 company sponsors a supplemental pension plan that is available to middle managers making a little over $100,000 per year, many of which work for the company's retail entity. The company noted the difficulty in

calculating annual accruals for this type of plan and the fact that the value of annual accruals often varies significantly from year to year due to interest rate changes and eligibility for early retirement. To the extent an accrual under the supplemental pension plan exceeded the limit, it is not clear how the company could "fix" the pension plan formula to avoid an excess accrual. The company also noted that the impact of the one-time pay limit would be even more severe because other forms of compensation provided to these managers, such as RSUs, performance units and severance pay, would also be aggregated with accruals under the supplemental pension plan in applying the limit. As a result, the company advised us that they may discontinue the supplemental pension plan if the annual limit is enacted.

Another Fortune 500 company provides a supplemental pension plan to its key executives (about 4,000 U.S. employees). The covered employees do not elect into the plan, it is provided automatically. The assets are also at a substantial risk of forfeiture until the employee reaches age 60. If an employee leaves the company before age 60, he or she receives nothing from the plan. The plan benefit is unfunded before and after an employee attains age 60. It is paid out on retirement as a life contingent annuity (either single life or joint & survivor) with a five year guarantee. The Senate proposal appears to apply to the supplemental pension plans at the time the plan vests (i.e. at age 60). Under the plan, until an employee reaches age 60, the benefit is subject to a substantial risk of forfeiture. At age 60, the benefit is vested and also deferred, since the employee has no choice but to defer payment of the vested benefit as a life annuity when that employee retires. The amount of the deferral at age 60 presumably would be the then present value of the life annuity. A modest lifetime annuity viewed that way would violate the $1 million cap and the employee would be subject to a regular income tax and 20 percent penalty tax that would significantly reduce their benefit.

For other employers whose supplemental pension plan may follow the vesting schedule of their qualified plan, the situation is more acute. In such a case, the vested annual accrual is likely to be subject to the new limitations. The calculation of that amount (which can depend upon salary levels and incentive compensation payouts) may be impossible until after the fact, meaning that the employee will never know, until it is too late, whether he has "deferred" too much.

Bonuses and Incentive Programs: Many employers structure their bonus programs to fit within the regulatory exception from 409A for compensation that is paid upon vesting (or 2½ months after the year of vesting.) It is not uncommon, however, for employers to find that they cannot meet this strict 2½ 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 payment being subject to 409A. Some employers may need to wait longer for performance criteria to be ascertained, financials certified, etc., resulting in the payment being subject to 409A and the one-time pay limit. In other instances, an employee may vest in increments over the performance period or upon reaching retirement age but is not paid until the end of the period, which also would result in the payment being subject to 409A and the one-times pay limit. Finally, employers may, to align their interests with those of their managers, encourage or allow that bonuses be deferred until retirement rather than being paid currently. Section 409A specifically allows for voluntary deferral of performance-based pay. The new limits would make such a voluntary deferral difficult and often impossible.

Private Equity: Many private companies (including start-ups) cannot readily conform to the specific administrative rules provided under the 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. Under the Senate bill, private companies could not provide this type of equity grant to employees unless the grant does not exceed the one times pay limit. Because "earnings" on the equity also are subject to the proposed limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the equity increased beyond the limit.

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 Senate bill limits the business from making any promise that exceeds one-time pay for employees.

Attachment B

Real Examples of Employees Affected by Section 226

Asian male manager, age 57

Base Salary: $180,500
Average 5-year W–2: $142,000
Bonus deferral (deferred in 2006 by irrevocable election made in 2005): $59,000
SERP earnings (not payable until after termination by irrevocable distribution election): $80,000
Deferred Compensation earnings (irrevocable distribution election): $6,500
Total 2006 "deferrals": $145,500
Amount above allowance: $3,500

Presumably, this would mean a 20% excise tax plus the income tax on the entire amount.

Caucasian female manager, age 50

Base Salary: $197,000
Average 5-year W–2: $144,000
Bonus deferral (deferred in 2006 by irrevocable election made in 2005): $72,000
SERP earnings (not payable until after termination by irrevocable distribution election): $75,000
Deferred Compensation earnings (irrevocable distribution election): $8,000
Total 2006 "deferrals": $155,000
Amount above allowance: $11,000

Presumably, this would mean a 20% excise tax plus the income tax on the entire amount

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Chairman RANGEL. Thank you, Mr. Petrini. As an aside, are you familiar with the International Labor Organziation (ILO) suggestions, provisions in the trade laws, as relates to the NAM?

Mr. PETRINI. No, Mr. Chairman, I am not.

Chairman RANGEL. It's not on today's schedule, I just thought—thank you so much for your testimony.

Edward Kleinbard, partner, Cleary Gottlieb Steen & Hamilton, New York, on behalf of the Securities Industry and Financial Markets Association. Thank you so much for taking time to share your views with us this morning.

STATEMENT OF EDWARD D. KLEINBARD, PARTNER, CLEARY, GOTTLIEB, STEEN & HAMILTON, LLP, NEW YORK, NEW YORK, ON BEHALF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. KLEINBARD. Thank you, Chairman Rangel, Ranking Member McCrery, and Members of the Committee. Thank you all for inviting me to testify today on behalf of the Securities Industry and Financial Markets Association.

I am here to speak in opposition to a Senate proposal that would reverse settled law by increasing the tax burden on contingent payment convertible bonds. Contingent payment convertible bonds are simply publicly issued debt instruments with two additional features.

First, the holder of a contingent payment convertible bond can convert that instrument into the issuer's stock at the holder's option, just as is true of a traditional convertible bond.

Second, issuers of contingent payment convertibles make an economically meaningful promise to pay additional cash bonus interest, if certain future conditions are met. In this respect, contingent

convertibles are similar to other contingent payment bonds, such as one indexed to the price of gold or to the S&P 500.

Contingent payment debt instruments may sound exotic, but they in fact are a common and important financing tool that many American corporations have used over the last few years to raise over $90 billion in capital. The IRS and Treasury have extensively reviewed the tax analysis of contingent payment convertibles, and these experts confirmed the legal analysis that the Senate bill now proposes to reverse.

The Senate bill would undo settled law by cutting back the interest deduction available to an issuer of contingent payment convertibles. Instead of deducting its true cost of borrowing, an issuer would be limited to deducting no more interest than it could have deducted if it had issued traditional convertible bonds.

At the same time, investors would be taxed on much higher amounts of income, as if they had purchased a pure contingent payment bond linked, for example, to the price of gold.

Why is the Senate proposal wrong, as a matter of tax policy? Why should simply adding a promise to pay bonus interest to a traditional convertible bond change the tax results for bond issuers and investors, alike? That, in essence, is the Senate Finance Committee's argument.

Our response is that the Senate Finance Committee's reasoning is problematic for four reasons. First, it claims to treat contingent payment convertible bonds like other convertibles, when, in fact, it does not do this.

The proposal creates a worst of all worlds result, in which issuers' deductions are capped at an artificially low number, just like traditional convertible bonds, but a holder's income is not similarly capped. Instead, holders are required to include, as taxable interest income, their entire economic profit, including the value of any stock they obtain on conversion.

Second, the Senate proposal denies issuers a full deduction for the real economic cost of their borrowings. The Senate proposal overlooks the economic reality that an issuer's true cost of borrowing includes the value of the conversion option that it conveys to investors, just as the issuance of compensation options has real value to an employee, and a real cost to the issuer.

Third, the Senate proposal will be difficult for the IRS to administer, because it mistakenly assumes that there is a single, typical convertible bond yield for every issuer.

Fourth, the Senate Finance Committee's underlying assumption was that the extra contingent payment features in contingent payment convertible bonds are economically meaningless, and therefore, should not drive the tax results. This assertion is incorrect. The IRS today audits exactly this question, and requires an issuer to demonstrate that its promise to pay bonus interest have substantial economic substance.

The Senate Finance Committee acknowledged in its legislative history that there was an irreducible logical inconsistency in the current taxation of convertible instruments. The Finance Committee argued that the resolution of the question should be deferred until it can "be addressed legislatively through comprehensive reform of the tax treatment of financial products."

We agree with this sentiment, but we respectfully submit that it is the Senate proposal that is introducing piecemeal change, without regard to the larger context. The tax experts at Treasury and the IRS exhaustively considered how contingent payment convertible bonds should fit into the larger tax system, and came to a carefully reasoned conclusion. That conclusion should not now be overturned in this ad hoc fashion. Thank you.

[The prepared statement of Mr. Kleinbard follows:]

Statement of Edward D. Kleinbard, Partner, Cleary Gottlieb Steen & Hamilton LLP, New York, New York, on behalf of the Securities Industry and Financial Markets Association

Chairman Rangel, Ranking Member McCrery, and members of the Committee, thank you for inviting me to testify. I am a lawyer in private practice with the firm of Cleary Gottlieb Steen & Hamilton LLP, and I am testifying today on behalf of the Securities Industry and Financial Markets Association ("SIFMA").

I am here today to speak in opposition to Section 230 of the Senate-passed version of H.R. 2, which would reverse settled law by changing the taxation of "contingent convertible" debt instruments. Before addressing this issue, I would like to note SIFMA's opposition to other provisions in the Senate bill. Specifically, SIFMA has serious concerns with the Senate bill's provisions that would deny the deductibility of settlement payments, impose an arbitrary cap on nonqualified deferred compensation arrangements and expand the Section 162(m) limit on the deduction of executive compensation. These proposals have unintended consequences that would go beyond the stated goal of closing loopholes and tax shelters.

Turning to the purpose of my testimony, contingent convertible bonds are simply debt instruments that are publicly issued by U.S. corporations, just like any other debt offering. These bonds have two additional features. First, a holder of a contingent convertible bond can convert it into the issuer's stock at the holder's option. (This feature is common to both contingent convertible bonds and traditional convertible bonds.) Second, contingent convertibles also contain an economically meaningful promise to pay additional cash "bonus" interest if certain future conditions are met. (This feature is common to other forms of contingent payment debt obligations as well.)

Contingent convertible debt instruments may sound exotic, but they in fact are a common and important financing tool that many American corporations have used over the last few years to raise over $90 billion in capital. These corporations often are growing companies with lower credit quality ratings for which the markets for more traditional capital markets instruments are foreclosed, or prohibitively expensive.

The Senate bill would undo settled law by cutting back the interest deduction available to issuers of contingent convertible bonds. Instead of deducting an amount of interest comparable to what they can deduct on all of their straight debt or on other contingent debt obligations, issuers would be limited to a smaller deduction equal to their cash interest payments, as is also true for traditional convertible bonds. This result in turn understates an issuer's true cost of borrowing.

The IRS and Treasury have extensively reviewed the tax analysis of contingent convertible bonds, and these experts confirmed the legal analysis that the Senate bill proposes to reverse. In doing so, these experts also confirmed that the current law has a built-in bias that favors the government because issuers' tax deductions for these instruments are subject to a special cap, while investors' taxable interest income inclusions are not. As a result, under current law, a contingent convertible bond investor's ultimate taxable interest income will often *exceed* the issuer's interest deductions.

For example, imagine a typical issuer that normally could borrow at 8 percent, but, in order to conserve its cash, decides to issue a contingent convertible note. Because the right to convert the debt into issuer stock is valuable, one might expect, in a typical issuance in today's market, for the issuer to pay cash interest on the debt of, say, 2 percent. Under current law, the issuer would be allowed a deduction of 8 percent, which represents the expected total cost of the issuer's debt. Under the Senate proposal, the issuer would deduct only 2 percent for its out-of-pocket cash costs. This is the same deduction that would be allowed for a traditional convertible bond. If, at the end of the day, the bond gets converted into stock, and it turns out that the holder realized an effective yield on the bond of 20 percent, that entire 20 percent is included in the investor's taxable income, but the issuer's effective interest deduction will be subject to a cap of 8 percent.

Why is the Senate proposal wrong as a matter of tax policy? After all, it appears to conform the taxation of contingent convertibles to the rules for traditional convertible bonds. That sounds superficially sensible. Phrased differently, why should the addition of a contingent interest feature give issuers a different tax treatment? That in essence is the Senate Finance Committee's argument.

The Senate Finance Committee's reasoning is problematic for four reasons:

First, it claims to treat contingent convertible bonds like other convertible bonds. However, it does not do this. The proposal applies the convertible bond rules for purposes of taxing the issuer, but does not apply the convertible bond rules for purposes of taxing the investor. This creates a "worst of all worlds" result in which issuers' deductions are limited to their out-of-pocket cash expenses, but holders' interest income is not similarly capped. Instead, holders are required to include as taxable interest income their entire economic profit—both the cash they receive and the value of any stock they obtain on conversion.

Second, the Senate proposal denies issuers a full deduction for the real economic cost of their borrowings. The Senate proposal overlooks the economic reality that an issuer's true cost of borrowing includes the value of the conversion option that it conveys to investors. A conversion option has real value to investors, and a real cost to the issuer, just as the issuance of compensation options has real value to an employee, and a real cost to the issuer.

Third, the Senate proposal will be difficult for the IRS to administer because it mistakenly assumes that there is a single typical convertible bond yield for every issuer. In fact, convertible bonds are complex instruments to construct, and the relative mix of cash interest payments and conversion premium varies from deal to deal.

Fourth, the Senate Finance Committee's underlying assumption was that the "extra" contingent payment features in contingent convertible bonds are "economically meaningless," and therefore should not drive the tax results. This assertion is incorrect. The IRS today audits exactly this question, and requires an issuer to demonstrate that the additional contingent interest that it promises to pay is economically meaningful—the contingency must be non-remote and substantial.

Taking a step back, I believe that a persuasive case can be made that it is the taxation of traditional convertible bonds, not the taxation of contingent convertible bonds, that is the logical outlier in the current system. Indeed, traditional convertible bonds are the *only* debt instruments of which I am aware that are not taxed under the "*economic expectations* " model. This model, which is based on the observation that rational issuers and investors expect that all debt instruments, however constructed, will over time produce a yield approximately the same as the issuer's normal cost of borrowing. The treatment of traditional convertible bonds is an historical anomaly, and its preservation in today's tax law can best be understood as a "grandfathering" of a preexisting market instrument.

In reality, the grandfathered tax rules for traditional convertible bonds contain a hidden, and underappreciated, tax deduction for *investors*. That is, in a traditional convertible bond, investors are permitted to take what should be ordinary interest income and use that to acquire a capital asset—an option to purchase issuer stock. Effectively, then, the traditional convertible bond analysis permits *investors to make tax-deductible investments in capital assets.*

The Senate Finance Committee describes the taxation of traditional convertible bonds as consistent with "the current operation of the Code and general tax principles." But why do we want to elevate to a general principle of law a tax result that gives investors the equivalent of tax-deductible investments in capital assets, and that at the same time takes away from issuers—often relatively young companies trying to preserve their cash flows—a tax deduction for their true economic cost of borrowing?

In its explanation of the Senate bill, the Senate Finance Committee acknowledges that there is an irreducible logical inconsistency in the current taxation of convertible instruments, and argues that the resolution of the question be deferred until it can be "addressed legislatively through comprehensive reform of the tax treatment of financial products." We agree with this sentiment, but we respectfully submit that it is the Senate proposal that is introducing piecemeal change, without regard to the larger context. The tax experts at the Treasury Department and the Internal Revenue Service exhaustively considered the issue of how contingent convertible bonds should fit into the larger tax system, and came to a carefully-reasoned conclusion. We submit that these experts' analysis of the "the current operation of the Code and general tax principles" is correct, and should not be overturned in this *ad hoc* fashion.

Chairman RANGEL. I want to thank all of you for taking time out. Could each of you very briefly illustrate an example of the negative impact of the retroactivity of the deferral bill? We will start with you, Mr. Kleinbard.

Mr. KLEINBARD. Yes. section 162(M)'s retroactive impact means that if a company has a written contract with an employee that is legally enforceable, legally binding against the company, but which requires compensation to be paid this year or next year, the consequence of the Senate bill would be to subject that existing contractually binding agreement to the limitations of revised section 162(M).

So, these are contracts which the company simply can't tear up. They are enforceable today by the employee against the employer. Yet, the consequences will be a punitive effect by disallowing the interest expense, a punitive tax to the employer, in the respect of a pre-existing arrangement with respect to existing compensation.

Chairman RANGEL. Changing the tax law would not be a defense to your contractual obligation?

Mr. KLEINBARD. No, sir. No. The contract does not typically contain a change of law "out" that would permit the company to tear up the contrast.

Chairman RANGEL. Mr. Petrini.

Mr. PETRINI. I think, sir, in that regard, it wasn't unusual for companies to try to avoid violating the provisions of 162(M). Many companies made it a policy and put it in their policy statements that they would not pay compensation that would exceed the 162(M) limits, and as a result, required certain executives to defer compensation that would not otherwise have been deferred, but would have been paid currently, requiring those executives to put that compensation at risk of the company, and the company's continued performance, in unfunded deferred compensation, taking advantage of the fact that under the 162(M) that's currently drafted, that after an executive retired, he was no longer one of those who was subject to 162(M).

To now retroactively change that, means that we have in place many deferral arrangements which were specifically designed, and which were done basically involuntarily, and forced upon executives in order to comply with the 162(M), which, as a result of the change in 162(M) now, would cause those very payments to be nondeductible.

So, the entire rationale for requiring deferral of certain amounts in excess of $1 million would have been defeated. It doesn't change what executives can be paid, it doesn't do anything to change their pay policies retroactively. Frankly, we believe that if executive pay is the issue, then it should be addressed through the work that Chairman Frank's Committee is doing, not through the tax code.

Chairman RANGEL. Thank you. Mr. Heaslip.

Mr. HEASLIP. I generally agree with Mr. Petrini. Individuals and corporations made deferral decisions based on the rules as they existed at that time. It's troubling that Congress would consider changing the law and applying it retroactively. I think it under-

mines taxpayer confidence in the system, and makes it very, very difficult to set compensation policy within a company.

The original 162(M) legislation had an explicit grandfather of binding contracts and agreements. We think this approach should be maintained. There is also an effort to extend the covered employee group and the current Securities and Exchange Commission definition. While this might not seem to be problematic, I caution that it adds complexity. To the extent that we can unify the rules, and speak in consistent terms, it makes for a more coherent and identifiable policy.

So, retroactivity is something that we think is problematic, and we applaud your efforts so far to make any changes applied prospectively.

Chairman RANGEL. Mr. Bentsen.

Mr. BENTSEN. Enforcing the passive-loss retroactively would trap a number of transactions with an original equipment cost in excess of $800 million. There are transactions that the IRS has already passed on, and not found—not challenged, and these are transactions that go back to the mid-1990s, multi-year transactions involving the financing of rail equipment, manufacturing equipment, and the like.

In addition, Mr. Chairman, as you know, the existing provision has already had unintended consequences as it relates to the cross-reference rules that were included. In fact, the final rules have not fully been promulgated because of concerns about the unintended effects of the existing Act.

Mr. Chairman, you and the prior Chairman, Thomas, and the respective Chairmen Bachus and Grassley had written to the then-Treasury Secretary Snow, in 2005, raising concerns about the cross-reference rules. We believe the Senate bill would then impose that cross-reference provision retroactively, as well, which would exacerbate the problem.

Chairman RANGEL. The Chair would like to recognize, for questioning, the ranking Member, Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman. Mr. Bentsen, would this retroactive application of the Senate provision in any way undermine the financial viability of some of those arrangements that were entered into in the mid-1990s?

Mr. BENTSEN. Our understanding, from—is that under FASB guidance, imposing 470 prospectively would cause members to have to go back and recompute their books from the inception date of the lease. That would cause them—because it would be a changing in the cash flow stream, that would cause them to have to restate—potentially, to restate their books. So, in addition to a tax increase retroactively, it also could have financial reporting consequences, as well.

I might add, Mr. McCrery, that my members tell me that they view this as having—the retroactive nature of this—as having a dramatic impact on the leasing market, from an investor perspective, going forward, as well, well beyond the intent.

Mr. MCCRERY. Thank you. Mr. Heaslip, why do companies like PepsiCo have these non-qualified deferred compensation plans, in a nutshell?

Mr. HEASLIP. Let's take the case of an elective deferral program. There are three primary reasons. The first is that they incur savings for retirement, which we think is good public policy.

Since the plans are unfunded, and the deferrals are at risk, they provide an extra incentive for employees to ensure the continuing health and success of the organization, so that the obligations can be paid out at that point in the future, when they retire.

Then, third, companies can use the deferred moneys to invest in their businesses. Instead of paying them out in current cash, we can take the funds and provide jobs, or buy equipment, or build plants, or use them elsewhere.

Mr. MCCRERY. Well, you didn't mention, as one of the reasons, that the employee who defers his income avoids taxation. Does the employee, in fact, avoid taxation on that income, should he receive it in the future?

Mr. HEASLIP. The employee defers taxation.

Mr. MCCRERY. That's different from avoiding it.

Mr. HEASLIP. They don't avoid taxation, they defer taxation, and the matching principle still applies, so that the company does not get a tax deduction for the payment until the employee realizes the payment and pays taxes on it.

Mr. MCCRERY. Now, you mentioned, in the course of one of those reasons, that the deferred compensation was "unfunded and at risk." What does that mean?

Mr. HEASLIP. What that means is that, unlike a traditional pension plan, for example, assets are not set aside or secured, in order to pay those obligations. The company pays those obligations out of cash flow at that point in the future, when they become due.

Mr. MCCRERY. Is that by choice of the corporation, or is that by law?

Mr. HEASLIP. That is by law.

Mr. MCCRERY. In fact, the American Jobs Creation Act that we passed recently tightened that criteria, didn't it?

Mr. HEASLIP. The American Jobs Creation Act imposed a series of additional requirements around the timing of election deferrals, the payout of election deferrals, the form of election deferrals, and it put in special provisions for executives that are considered key employees, in respect to when they can take their deferrals.

We are still digesting those new regulations. Final guidelines have not yet been issued. We would propose for final clarification of existing law before we introduce new complexities.

Mr. MCCRERY. So, since the deferred compensation is taxable when it's finally given to the employee, and since that deferred compensation is unfunded and at risk, as you say, it really does make the employee very interested in the performance of the company, because, as you said, the ultimate payout of that deferred compensation is not dependent upon tapping into some fund that is set aside. That would be illegal. It is dependent on cash flow of the corporation.

Mr. HEASLIP. Exactly.

Mr. MCCRERY. It really does tie that employee's interest to the interest of the shareholders, the interests of the corporation, the interests of the officers of the corporation.

Mr. HEASLIP. That's correct.

Mr. MCCRERY. Which all goes into, we would hope, better corporate governance.

Mr. HEASLIP. Better performance for shareholders.

Mr. MCCRERY. Right. Now, if the Senate provision were enacted into law, would it impact only the bigwigs in the corporation, the top executives?

Mr. HEASLIP. In our corporation, approximately 1,000 individuals are limited in the amount that they can receive from the qualified pension plan, and receive a portion of their pension benefits from the non-qualified restoration plan that I mentioned. So, far beyond the scope of the CEO or the named executive officers.

Mr. MCCRERY. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman. Yes, I think you have presented very articulately some problems. Have any of you testified before the Senate on these issues?

Mr. HEASLIP. No.

Mr. LEVIN. No. Do you know, have there been hearings on these issues before the Senate? Maybe you don't know that. Mr. Bentsen, do you know of any hearings?

Mr. BENTSEN. Certainly not this year, I don't believe. There were hearings back in 2003, during the initial—as the Jobs Act, I guess, was initially being created. I might add, during those hearings when the legislation was introduced, as it relates to our concern, it was stated as prospective. So the retroactive nature is a relatively new phenomenon.

Mr. LEVIN. I take it, Mr. Chairman, there is nobody here from Treasury?

Chairman RANGEL. No, they declined to testify.

Mr. LEVIN. The punitive damages play a role, and there are differing opinions as to how effective it might be. I think your testimony should be taken not as an attack on the basic structure, but whether we should change the taxation of punitive damages. Isn't that correct?

Mr. PETRINI. That is absolutely correct. The issue really, again, gets to be the matching principle, that if punitive damages are income to the recipient, it makes sense that they be deductible to the payor.

It is also the issue that the punitive damages is such a vague concept, or it's a concept that isn't consistent from jurisdiction to jurisdiction, and it is very difficult to have a—what effectively would be a punitive tax treatment a payment that is being made that is both taxable to the recipient and is non-deductible to the payer.

Again, the question was asked about retroactivity. It would have a chilling effect on cases that are currently pending, or that may be an initial decision in, and a decision being made as to whether they will appeal.

So, we are not at all questioning the validity of punitive damages as a substantive matter of law. We are just saying that the tax treatment shouldn't be singled out from the general principles that we have of an item being taxable to one person and deductible to another.

Mr. LEVIN. Mr. Heaslip, you said in your testimony that there were about 1,000 employees who could be affected of your company. Mr. McCrery questioned you, I think, very effectively about that. Is there any reason to believe that the situation in your company would be unique, or that this issue would apply to a substantial number of employees, other than the CEOs and the higher echelon personnel, in other companies? Do you have any insight into that?

Mr. HEASLIP. The limits upon qualified plan benefits apply to all plan sponsors. So, any company who sponsors a defined benefit plan, like we do, is going to be subject to the same qualified plan limits.

I would further kind of suggest that this is a growing problem, because those qualified plan benefits are not moving at the same rate as pay is. For example, the qualified plan limit in 1989 was about $200,000. Today, 16 or 17 years later, it is $225,000. So, we have a much, much larger group of employees who receive benefits from the restoration plan today than we did 15 years ago, and I would expect that trend to continue.

Mr. PETRINI. Mr. Levin, if I could, because we can also offer a perspective, being a much smaller employer than Pepsi—we have roughly 10,000 employees in the United States, which I'm sure is dwarfed by PepsiCo—and we would have about 300 employees who would be potentially impacted, because we allow all employees who receive annual cash bonuses to voluntarily defer bonuses, and they have other forms of deferred compensation.

So, if Air Products is an example, on an employee base of 10,000, we have 300 that are affected. So, it's a very large problem.

Mr. LEVIN. For those of us who have been very sensitive to the future of defined benefit plans, it strikes me that this testimony should be taken into account. Thank you very much.

Chairman RANGEL. Thank you. Mr. Johnson, from Texas.

Mr. JOHNSON. Thank you, Mr. Chairman. I appreciate your testimony. I tell you, the—I used to be on the education Committee, as you know, and Mr. Heaslip was a witness over there a couple of times. You have always been clear and very useful in your testimony.

This misguided revenue measure that we have been talking about here that our friends in the Senate have passed, in your testimony you said that the Senate provision would penalize early retirement benefits that simply mirror those in traditional defined benefit pension plans.

When we revised the pension plans here last year, we tried to do it in a way to keep those plans in force, and it was tough. As you know, it was marginal whether some companies kept them. I guess yours did. What I would like to know is if this retroactivity goes into force, would you all do away with your defined benefit plans?

Mr. HEASLIP. It certainly would add another challenge to the many that already face defined benefit plan sponsors. As I said in my testimony, although I have a specific concern about how the individuals in our restoration plan would be affected, I have a broader concern about the implications of this for the plan in general.

I think once we disenfranchise middle and senior managers from a defined benefit plan, it just simply adds another challenge or barrier in an already challenging environment.

Mr. JOHNSON. Well, it's a difficult position to be in. You also said it might force managers to leave the company, so they could just pay taxes on their deferred compensation. You talked about deferral and various forms of compensation all lumped together, a 20 percent penalty because of—the income is above the annual base.

Isn't it possible that this might undermine long-term corporate planning, and just further induce corporate raiders to buy companies, or figure out how to get around the law, if the law is not fair?

Mr. HEASLIP. That's true, sure.

Mr. JOHNSON. Do you want to comment?

Mr. HEASLIP. It certainly makes individual planning challenging, and could have the effect that you hit on, which is somebody who triggers taxes and penalties if they need to leave the company in order to get the cash to pay those taxes and penalties, and that's certainly not something that we want the tax law to encourage.

Mr. JOHNSON. Thank you. Ken, it's good to have another Texan with us today. Thanks for being here.

I think you hit it right on the head when you talk about increased taxes retroactively. They're just not right. I do not think we can travel back in time to undo transactions that were legal at the time. The laws of physics and good tax policy prevent, or prohibit, time travel, I would say.

One of the cries we used in 1994, when we won control of this place, was opposition to retroactive taxes. I don't think we can go back to that. I would like your comments on it.

Mr. BENTSEN. Well, Mr. Johnson, I agree with you from the standpoint that I think retroactive tax policy is something that this Committee and the congress, generally, has opposed, because of the impact that it has on both investors and how they will deploy capital for any length of time, and quite frankly, on the ability of Congress to incent investment as they see fit.

So, I think you are accurate. I would, if I might, very briefly clarify in response to Mr. Levin regarding any hearings, there had not been any hearings on the retroactive nature of this. The Senate did, subsequent to the introduction of the Jobs Act, take up amendments to this effect to go retroactive. The House wisely and consistently rejected those amendments, as it has as late as this year.

I just wanted to make sure I clarified that point. Yes, I think you're right, Mr. Johnson, that this is something that is quite out of character for how the congress has addressed tax policy.

Mr. JOHNSON. Right on. Thank you, sir. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you, Mr. Johnson.

Dr. McDermott.

Mr. MCDERMOTT. Thank you, Mr. Chairman. This Committee has changed in the years I have been here. Last week we had a hearing on global warming, and we had a whole panel, and they all agreed, both the Republican witnesses and the Democratic witnesses, that there was global warming. The question was what you ought to do about it.

Today we have a panel of four people, and I guess they couldn't find anybody to come in and testify that there was some good in what's been proposed by the Senate. How—explain to me how the Senate could have looked at these provisions and thought, some way, it was good for business. I assume this is what it is, because if we raise the minimum wage, that's bad for business. Now we've got to give business something that is good for business to balance that out.

What in the world did they think they were giving to business, or—out of this, that would somehow ameliorate the problem of raising the minimum wage? Can you help me understand what the thinking might have been over there? Somebody. Mr. Petrini, you could start.

Mr. PETRINI. Thank you. I don't know whether there was any intent to do something that was good for business. I think one can look at the four provisions that I talked about, and see how somebody could think that there was a policy behind them. As we suggested, we think that the policy was misguided, because the provisions themselves are not drafted tightly enough.

The settlement provision, for example, one can look at that and say, "Yes, it makes sense that a company shouldn't be able to deduct the cost of paying a settlement where they have a violation of law, and they have reached a settlement with a government agency."

However, a lot of what we think would be the restitution part of that settlement, it would be deductible. The parts that become nondeductible are those parts that we often do that go over and above the perceived violation. So, we think that the way it was drafted is just too broad. You look at the deferred compensation. Everybody agrees—and one can assume that the deferred compensation changes had their genesis in this belief that executives are overpaid.

As I suggested, I think that if you want to align executives and shareholders alike, you should be encouraging executives to take their compensation in a deferred manner, rather than taking it currently, because that way, they have a lot of skin in the game, as they like to say.

So, I don't think that there was necessarily any intent to help big business, but I think there are some policy reasons behind some of these changes that are proposed. We just don't think that the policy was well thought-out, or that the proposals get at the harm that was really being addressed.

Mr. KLEINBARD. Mr. McDermott, I think Mr. Petrini's remarks are absolutely on point. What I would—to summarize our thoughts on it, is that in several respects—perhaps not in the contingent payment converts, but in some of the other cases—there is a core of an issue that deserves to be thought about and addressed, but that the Senate proposals, as they have been enacted in the Senate bill, are just profoundly undercooked.

They are not yet fully developed proposals. They have lots of collateral consequences, which we believe to be completely unintended, or underappreciated. The ideas need to go back in the oven for a proper set of—for the appropriate time, to develop properly

targeted, narrowly focused issue that does no harm, as well as solving the very narrow problems that were the original target.

Mr. MCDERMOTT. It's probably a good time, with St. Patrick's Day, to enact Murphy's Law. That sounds like what you're saying. Mr. Bentsen?

Mr. BENTSEN. Dr. McDermott, I think there is a sense that perhaps imposing this provision retroactively, in the most compassionate sense, is trying to go after certain transactions that have been challenged by the Government.

However, in the way that it's done, first of all, serves to undermine confidence in our tax system by doing it retroactively, and I think has far reaching implications beyond just those provisions that may be in question, and certainly captures many more.

Second of all, I think undermines our whole system of due process rights that we have in this country. Cases that should be challenged will be challenged. The idea that this is somehow relieving the Government from bringing suit is something generally the congress doesn't do, just as it's something that Congress generally doesn't do retroactive tax policy.

So, ironically, I think it has far-reaching unintended consequences.

Mr. MCDERMOTT. Thank you. I still have my question as to what did they think they were doing? Thank you, Mr. Chairman.

Chairman RANGEL. We may find out. Mr. Weller is recognized for 5 minutes.

Mr. WELLER. Thank you, Mr. Chairman, and I commend you for conducting this hearing today. As one who supports increasing the minimum wage, I also want to commend you for the bipartisan approach you have taken in putting together a package of tax relief for small business, as part of the package which helps both workers, as well as small business. The bipartisan approach that you and Mr. McCrery have worked out I commend you on. It sets a great precedent for this Committee and this congress. I want to thank you for showing that kind of leadership.

Mr. Chairman, I want to thank you and the panel for this hearing. Clearly, decisions that investments by business make, many of them are based on tax consequences. Many of us on this Committee have raised concerns about what we call retroactive tax increases.

I particularly want to ask about the decision by our friends in the other body to expand transactions subject to the 2004 conversion rules. I was going to direct this question to Mr. Petrini, if you would. If others want to respond—but I will direct it to you, Mr. Petrini—is when the Senate voted to expand transactions subject to 2004 inversion rules, would you classify that as a retroactive tax increase?

Mr. PETRINI. Yes, I think you would have to.

Mr. WELLER. I guess I have always been told that consistency and confidence in tax policy will remain the same in the foreseeable future is a factor on businesses making decisions on investing and job creation.

This precedent that would be set when it comes to a retroactive tax increase, what will that do to the confidence level, business decisionmakers, when it comes to making business decisions when they consider tax policy with this retroactive tax increase?

Mr. PETRINI. Well, I think it's very difficult. Considering my role as a chief tax officer in a company, it's very difficult if you have to give senior management answers to their questions, whether it's inversions, deferred compensation, or anything where you say, "Well, that's the law today, and the law may change." They accept the fact that the law may change, and they will take the risk that it will change in the future for things that they do in the future.

If there is an inability to tell people that what you do today will be taxed under the rules that are applied today, and exceptions for binding contracts and commitments made, and you know, often billions of dollars—we're talking about significant capital projects—if you can't give that kind of certainty, it makes it much more difficult to operate in the U.S. tax system. Perhaps places U.S. companies, or companies wanting to do business in the United States, places the ability to do business at a global competitive disadvantage.

Mr. KLEINBARD. Mr. Weller, if I could?

Mr. WELLER. Mr. Kleinbard.

Mr. KLEINBARD. Thank you. If I could give a parallel answer, but from the perspective of the capital markets, as opposed to the corporate employer itself, Congressman Bentsen made a very important point, I thought, in his earlier testimony, that the retroactive change in the law, one, changed the perspective of participants in the leasing market.

The reason for that observation, I believe, is that if participants in the leasing market or in the capital markets, generally, believe that settled law is not, in fact, settled, there is a risk of retroactive change in law, the consequence of that is that they are going to have to charge more money. They are going to have to charge a risk premium for the risk that the law itself will change, as opposed to just credit risk or market risks.

So, every time you introduce a new kind of risk, the capital markets, which are very efficient, price that risk. Now, what you're effectively doing, is asking the capital markets to price not simply credit risk and market risks, and those kinds of risks, but also the change of law risk that settled, contractual expectations will not be honored by virtue of change in the tax outcomes, so that the allocation of income from a transaction will not be honored through the retroactive changes in law. That raises the cost of capital for every company.

Mr. WELLER. Of course, my classmate and former colleague is with us—good to see you, Ken, thank you for joining us today. Do you agree, have the same perspective on this retroactive——

Mr. BENTSEN. Absolutely, Mr. Weller, and I think that the counselor is absolutely correct. You think of the situations—say, United Airlines, for instance, in your State of Illinois, that investors will underwrite the cost of their airplanes.

The airline industry, as we know, is already fairly tight on margins in most cases—in many cases, negative margins from time to time. Their ability to operate is to have aircraft that they can put into the air on a regular basis. They have to pay a cost for that. If the cost for capital rises in that, that directly effects their ability to be an operating, or a going concern.

So, yes. I think this is very serious, far beyond the intended target.

Mr. WELLER. Thank you. Thank you, Mr. Chairman, you were generous with my time. Thank you.

Chairman RANGEL. The Chair would like to recognize the gentleman from Georgia, Mr. Lewis.

Mr. LEWIS OF GEORGIA. Thank you very much, Mr. Chairman. Thank you very much for holding this hearing. I thank members of the panel for being here today. Mr. Bentsen, it is good to see you again.

Mr. Bentsen, you must have some friends in the Senate that you could talk to and not just come before this Committee? I'm sure you have some wonderful friends there.

Mr. BENTSEN. Well, I think I do, Mr. Lewis. We finally have been talking to the Senate about this, as well. I think, as—and let me say I appreciate the Chairman for calling this hearing, and having not just us at this panel here, because it does give us an ability to really air these issues out.

I believe that the intentions of the Senate are well intentioned. I think that they have perhaps not taken the time to look at the implications of what they are trying to do here, as it relates——

Mr. LEWIS OF GEORGIA. One member of the panel said it's like cooking a meal, and I think you suggested it's not completely baked, and maybe they should put it back in the oven? Can I hear a reaction to——

Mr. BENTSEN. Well, in our case, I would say as it relates to retroactively tax policy, I don't know that retroactive tax policy is ever going to be fully baked. I think that it's something that is just a bad idea, which, if you go back and look—at least from my recollection—at prior tax acts, generally, consistently, the congress has tried to avoid retroactive tax policy where it involves the long-term deployment of capital, because of the impact.

So, I just don't think there is ever a situation where the congress is going to say, "Well, if we do something retroactive, we can raise a lot of revenue doing it," that the congress has just generally said, "That's just not a good idea." So I don't think there is every going to be a situation where you would come back and say, "Well, we looked at the issue, we studied it more closely, and maybe this works better."

Perhaps when—certainly on more complex financial issues, like the convertible bond issue, which I am not at all informed to speak on, but there are certainly technical things that I do think take time. Generally, the congress has always done that.

Mr. LEWIS OF GEORGIA. That's what he said. Mr. Heaslip, in your testimony you describe a plan that covers an approximate 1,000 senior managers at PepsiCo. The program seemed to mimic the company 401(k) plan. You described the program as a voluntary savings plan.

How would the section 409A provision affect this plan and its participants? What impact would it have?

Mr. HEASLIP. The plan that I am referring to is the elective deferral program, where executives can voluntarily defer a portion of their salary or bonus each year. It is similar to the 401(k), in that it offers the same investment options, but it's very different from

the 401(k), in that the money is at risk. There is no company match on this plan, as well.

This is the plan where, because earnings are being included in the deferral toward the one times cap, the amount of the deferrals become very unpredictable. A year of good investment performance could wind up triggering taxes and penalties on money that the executive has not received.

So, in effect, somebody who has saved for their entire career would wind up paying taxes and penalties because they're a disciplined saver, they are putting money away for retirement, and they weren't able to predict the stock market.

Mr. LEWIS OF GEORGIA. Do you have an estimate for retirement savings for the rank and file employees of a company, compared to the retirement savings for your high-level, well-paid executives?

Mr. HEASLIP. I do. Again, we provide a defined benefit plan that provides the primary vehicle for retirement security for all of our employees, and that's completely funded by the company. So, rank and file doesn't pay anything for that. Rank and file, about 65 percent participate in our 401(k) plan. Of our executives, about 30 percent participate in the elective deferral program.

Mr. LEWIS OF GEORGIA. Would the benefits under the plan be caught on the——

Mr. HEASLIP. Yes, the elective deferral plan would be.

Mr. LEWIS OF GEORGIA. So, you are telling Members of the Committee that what the Senate is proposing would have a negative impact?

Mr. HEASLIP. On savings?

Mr. LEWIS OF GEORGIA. Yes.

Mr. HEASLIP. For the individuals in that plan? Absolutely.

Mr. LEWIS OF GEORGIA. Thank you very much for being here.

Mr. HEASLIP. Thank you.

Mr. LEWIS OF GEORGIA. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you. Mr. Brady.

Mr. BRADY. I am not aware of any taxpayers entering into transactions after Congress enacted the legislation in 2004. Are you?

Mr. BENTSEN. No, sir, not to our knowledge. From what our members tell us, these transactions are effectively stopped with the passage of the Jobs Act.

Mr. BRADY. Well, it seems to me that with both the provisions, basically the Senate is trying to squeeze more money out of a problem that Congress worked together to solve already.

While I am not a big proponent of raising the minimum wage—I am a Chamber of Commerce executive by profession, worked a lot with small businesses, I think mandating a $5,000 pay raise will have a real impact on some of our small businesses—nonetheless, Chairman Rangel worked hard with the minority to craft a tax package in the House that actually tried to ease some of the impact of that minimum wage. I am very grateful for that.

I look at the Senate, and I think they're way off the mark, both in their tax provisions and their revenue raisers. I look at this provision as one of those issues.

To talk about the negative—or to reveal the negative impact Mr. Lewis just talked about, the Senate is not just changing rules in the middle of the stream, they are changing the rules 5 years after you crossed the stream. I think it has a real impact in the future, and can for you and Mr. Kleinbard.

Looking forward, what signal does this retroactivity send to taxpayers who are thinking about making future capital investments? Well, what does it say to them?

Mr. BENTSEN. Well, Mr. Brady, I would say, ironically, if you look at the Senate package, for instance, it contains certain provisions to create investment going forward, over a multi-year basis. A taxpayer who would be looking—an investor who might be looking at that would also be thinking, "Well, there is another provision within this bill that actually steps—reaches back and imposes a tax on me."

So, I would think twice about whether or not I would follow the other provisions that are contained in this bill, where I am going to be expensing benefits to make a long-term investment, because who is to say that next year they're not going to come back and reach back and take that back from me? Whereas, I might go put my capital elsewhere, where I feel more confident.

So, I just think it is quite problematic, the way it's structured, and quite frankly, undermines some of the other provisions that are in that bill.

Mr. BRADY. Encourage on one hand, and discourage and raise uncertainty on the other hand?

Mr. BENTSEN. Yes, sir.

Mr. BRADY. Thank you.

Mr. KLEINBARD. I would agree with what Congressman Bentsen said, and I would emphasize the theme that economics teaches us that the success of our country's economy has always been based on a notion of a rule of law, and the importance of having clear property rights, having clear enforceability of those property rights, and a clear relationship between—in connection with this Committee—the taxpayers and the Government, makes it possible to predict, with some certainty, what the consequences of your actions will be.

Let me take an over-the-top example, just to illustrate the point. If we had a world in which every homeowner was at risk, that 1 out of every 1,000 homes would just be randomly seized by virtue of a lottery by the Government, to be used to pay a shortfall in the revenue bill, that would affect housing prices.

Mr. BRADY. It's called eminent domain.

Mr. KLEINBARD. Eminent domain doesn't work by lottery, and in eminent domain you could get paid. In my example, it's just a lottery, the house gets taken away from you. It would affect your willingness to own a house.

The same is true here. Any time you have rules where there is a shadow of uncertainty, the capital markets will respond by pricing in that risk. The consequence of pricing in risk is that the cost of capital goes up.

Mr. BRADY. Well, thank you. You finished the point, I think, that Chairman Rangel has made, which is while Congress frequently changes rules in the middle of the stream, this Committee

has gone out of its way, historically, to not change those rules retroactively, to try to provide some consistency in Tax Code, in tax policy, especially in the areas of investment. Thank you, Chairman Rangel.

Chairman RANGEL. Thank you, Mr. Brady. The Chair recognizes Mr. Neal for 5 minutes.

Mr. NEAL. Thank you very much, Mr. Chairman. Mr. Heaslip, you have testified about the problems you see in the non-qualified deferred comp proposal. Many of us have also heard from businesses in our districts that this provision could hit middle or senior managers, not just necessarily CEOs.

Your testimony refers to one example of a manager earning $100,000 annually, who was laid off because of downsizing. This person's pay could be subject to the higher taxes because of the proposed revision.

Could you explain how this would work, and might you make some recommendations about how to better target this proposal, including a $1 million uniform cap, and limiting the provision to CEOs and certain other executive officers?

Finally, are these legislative changes—or, could they be done in an administrative manner?

Mr. HEASLIP. The example that you referred to is the example of where a manager is—loses his or her job because of a restructuring or a plant closing. In our company, we have a practice where, if an employee is within 5 years of retirement, and they lose their job because of downsizing, we provide a special early retirement benefit to them from the non-qualified pension plan.

The goal for the non-qualified benefit is to treat them more like an early retiree than a terminated employee, and to avoid the substantial loss in pension benefits that they would otherwise experience because of the plant closing.

We pay this benefit from the non-qualified plan, in order to comply with discrimination rules on the qualified plan. If this payment from the non-qualified plan were subject to the Senate's proposals, it could easily trigger the one times deferral cap, and invoke taxes and penalties at the same time that somebody is losing their job and entering a more uncertain financial future.

This scenario could be avoided through technical changes to the law, but it would be much simpler, and I think fairer, if it were resolved with something like the $1 million cap that you suggested.

Mr. NEAL. Okay. Mr. Petrini.

Mr. PETRINI. If I may, because we have a slightly different view, and that is that we continue to believe that it's a misguided notion that somehow deferred compensation is CEO-friendly and shareholder unfriendly. We believe that, one, you should get input from shareholder groups, so they see the alignment from deferred compensation.

We do believe, and our members believe, that when senior executives defer compensation, and the more they defer, it aligns their interests with the interests of the shareholders, as far as the going concern of the company, because those shareholders and the executives then have the same interests. The executive essentially becomes an unsecured creditor, really of the lowest rank, as far as security, in the company. That's not a bad place to have your ex-

ecutives, where they have a great amount invested in that company, and their ability to get that payout depends upon the company's ability to perform.

So, we would suggest that trying to limit CEO deferred compensation may, in itself, be one of those things that is half-baked. Somebody should really look at whether deferred compensation doesn't align CEO interests and shareholder interests better, and should be something that we should encourage, rather than discourage.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. The Chair recognizes Mr. Linder, from Geogia, for 5 minutes.

Mr. LINDER. Thank you, Mr. Chairman. Mr. Heaslip, explain again why you have this non-qualified plan. You said it was to make up a shortfall in other provisions?

Mr. HEASLIP. Yes.

Mr. LINDER. Explain that again.

Mr. HEASLIP. We have a defined benefit plan that we offer to all employees. The IRS code limits the benefits that can be paid from such a plan. So, we sponsor a non-qualified restoration plan to essentially mirror, or restore, the benefits that would normally be available from the qualified plan——

Mr. LINDER. How does that get around the IRS rule?

Mr. HEASLIP. Since the benefits are not funded, and they do not receive the favorable tax treatment that qualified plan benefits receive.

Mr. LINDER. Okay. It's just cash flow.

Mr. HEASLIP. It's just cash flow, unsecured.

Mr. LINDER. That is entirely elective?

Mr. HEASLIP. It is—no. There are no decisions.

Mr. LINDER. I see.

Mr. HEASLIP. The benefits are based on the same formula as we have in the qualified pension plan. There is no discretion or decisions or a choice between current cash and retirement benefits, on the part of the executive. It's simply a restoration adjunct to the——

Mr. LINDER [continuing]. The electability of it——

Mr. HEASLIP. That's correct.

Mr. LINDER. That's correct. Mr. Kleinbard, explain to me what an exit tax is, for people who have spent a long time living in the United States from Great Britain, and work for a foreign company. I assume they don't pay taxes on the money they make here.

Mr. KLEINBARD. An individual who is a citizen of Great Britain, sir, is your example, and who lives in the United States, and is a current resident of the United States?

Mr. LINDER. Yes.

Mr. KLEINBARD. Is taxed on his worldwide income by the United States, just as a U.S. citizen is, if they are permanent residents of the United States.

Mr. LINDER. What is the exit tax?

Mr. KLEINBARD. The exit tax—and this is an issue, obviously, to which—in the nature of my practice, I always like to do it with the books open in front of me, so I apologize if I don't get it quite right.

The idea of current law is that if it's a U.S. citizen, for example, who wishes to move to a foreign jurisdiction, we impose a tax on the unrealized gain, in respect of his or her assets and other contractual rights to income that they might have, so there is no advantage, you can't make money by simply tendering in your U.S. passport.

Mr. LINDER. What if it's a foreign citizen?

Mr. KLEINBARD. I don't know how the exit tax works for foreign citizens.

Mr. PETRINI. This was actually part of our written submission. If the individual is either a citizen or a green card holder, and gives up the citizenship or the green card, the exit tax applies. It has gone through various iterations. It seems like there was always some form of a revenue-raiser that is getting at expatriation.

It is revenue driven. Its original form was expatriation that was designed to avoid income tax, and it made a lot of sense, because it was getting at an abuse, where people were giving up citizenship, or giving up green cards, to avoid tax.

The situation our members see is that we try to bring foreign nationals in as—just as we send U.S. citizens abroad as expatriates, we bring foreign nationals into this country to work, sometimes for fairly long-term assignments. Someone, for reasons—often personal reasons—will obtain their green card. There is a natural flow of things. When they return to their home country, they will give up that green card. They are not expatriating to avoid tax, they're basically going home. It has become a very difficult situation for companies that employ both expatriates and inpatriates.

I suggest that it may actually be an issue that companies have to take into account considering where they locate their headquarters, because in this global economy, you want a continued flow of people of all nationalities in and out of your headquarters, so that you can really mirror the way your customers look.

Mr. LINDER. Do other nations, to your knowledge, do other nations have a tax like this?

Mr. PETRINI. I don't know of another nation that has this kind of a mark to market tax, simply because you have given up—especially as a permanent resident—non-citizen, and I don't know of another country that has it.

Mr. LINDER. Thank you. Thank you, Mr. Chairman.

Chairman RANGEL. Thank you. The Chair would recognize Mr. Tanner for 5 minutes.

Mr. TANNER. Thank you very much, Mr. Chairman. I will try not to utilize all of the time. Thank all of you for being here.

I came here this morning, primarily interested in hearing the discussion regarding the compensation and retroactivity issues, and I think you all have adequately covered them, and I thank you. I also will welcome Ken back. I am always interested in your observations of where we are here.

Now, one question. I was reading about part of the bill that has to do with trying to help the IRS discern what's a fine or a penalty, and there may be some problems with that, in terms of some unintended consequences. Mr. Petrini, could you address that, please?

Mr. PETRINI. Sure. The basic provision causes certain payments that were made as a result of a settlement to be non-deductible.

I think the problem we see with it is that it—the way it's drafted, and the reach of the bill may be a bit too broad.

The example that I am going to use is it would deal with any payment that is made in settlement of an inquiry into violation of—possible violation—of law. So, take the example that we have all seen of a spill of chemicals, or another item somewhere, that has caused a problem in a stream. You deal with the EPA, and you agree you're going to clean up the stream.

You have also had some bad press, so you decide you're going to build a park—on the bank of a stream, maybe build some areas for fish to spawn in the stream, and actually make the stream better than it was before.

Well, under this provision, your expenses in cleaning up your spill would probably be deductible, but the expenses that you incur in building that park, and in building that spawning area for fish, and in making the stream better than it was before, those go beyond what's necessary, so therefore, they would be non-deductible. To me, that's sort of counter to what you would think public policy would be, to try to encourage more of that kind of a civic spirit.

Mr. TANNER. That would represent a change in present law?

Mr. PETRINI. Yes. Under present law, these types of amounts you would spend are deductible, and they are not treated the same as a fine or a penalty would be.

Mr. TANNER. If a fish issue comes up again in conference, maybe we could get you to help us with some language. It would actually accomplish a good public policy in this area.

Mr. PETRINI. We would be very happy to do that.

Mr. TANNER. Thank you. I yield back the balance of my time, Mr. Chairman.

Chairman RANGEL. Thank you. Mr. Porter is recognized for 5 minutes.

Mr. PORTER. Thank you, and I appreciate the panel being here this morning. This may have been addressed, so bear with me.

What I hear regularly from families and businesses is that we are constantly changing the rules. Small investors and even folks that are of modest incomes have tried to plan their future. Some of these changes being retroactive and back to 2004, how does that impact the expansion of business, the expansion of an individual that would like to reinvest, create more jobs to help our economy? This changing the rules, how is that impacting?

Mr. KLEINBARD. Mr. Porter, I would answer that question by saying that I think that the point that we would like to make, at least, is that a small investor is not directly affected by the change in ILO rules. So, in that narrow sense, using that as an example, there is no effect.

The same is true for some of the other retroactive provisions of the bill. The question is if retroactivity is viewed not as extraordinary, but as ordinary practice by the congress, then the risk of retroactivity has to be priced into everything that people do. That, in turn, has a direct impact on the markets. It is another risk that needs to be priced, and the consequence of that is that the cost of doing business in the general sense, the cost of raising capital, goes up.

So, it's not the specific provision that necessarily affects the economy as a whole, but it's the question of the erosion of a principle, the principle being that tax laws are a—are something that—to which people can predict with certainty how they will apply.

Mr. PORTER. From the equipment leasing perspective, what impact does it have on—long-term, for your industry?

Mr. BENTSEN. Well, I would agree with Mr. Kleinbard. Investors, the people who are underwriting investments, and whether it's commercial aircraft, or if it's construction equipment, or rigs, or you name it, are going to—they will price that risk in. They are going to look at actions by the congress, and if they're making a 5, 7, 20, or 30-year investment, and they see the congress coming back and changing the rules retroactively, that will set a precedent that will apply to other types of transactions.

The gentleman is correct, is doesn't—the specific provision itself may only apply to some investors, but the market, as a whole, will look at this, and look at the precedent, and they will ultimately—markets are fairly efficient, and they will ultimately price that in, because the view will be, "Well, if Congress feels that it can be retroactive in this sense, in this instance, why can't they in others?" That's to say, "Well, we did it before, what's to stop us from doing it again?"

Mr. PORTER. Thank you.

Chairman RANGEL. The Chair recognizes Ms. Tubbs Jones for 5 minutes.

Ms. TUBBS JONES. Mr. Chairman, thank you very much, and thank you for hosting this hearing. Like my colleagues, I heard from my banking institutions and small businesses with regard to these changes.

Let me also say hi to my colleague, Mr. Bentsen, it's nice to see you. Welcome back to the House.

Let me start, if I can, with the gentleman from PepsiCo, Mr. Heaslip. In your testimony—and I don't believe you spoke specifically about this, but it is in your written testimony—about the impact of these proposals with regard to deferred comp would have laid-off workers or severed workers—maybe you did talk about this, maybe I missed it—about coming and going.

If you would, just very briefly, reiterate the impact this—these changes would have on laid-off workers, in terms of diverted comp.

Mr. HEASLIP. Sure. It's not clear. We did touch on it earlier, but there is a potential that severance benefits we pay from the nonqualified plan to severed employees could be swept up in this proposal.

While it's not clear if they are or not, it would seem to be a harsh and unintended consequence if we further penalized someone who had just recently lost their job as a result of reorganization with taxes and penalties on a payment that was supposed to represent some kind of retirement security for them.

Ms. TUBBS JONES. If you had your opportunity to mark the legislation, what would you propose that we would do? Leave it as it is, or make some other change?

Mr. HEASLIP. Without trying to be facetious, I would probably resort first to a shredder. Then I would—I actually——

Ms. TUBBS JONES. That specific provision, I apologize.

Mr. HEASLIP. That specific provision. I think if you stuck with a $1 million cap, it would eliminate most of the individual issues that I cited in my testimony.

Ms. TUBBS JONES. Great.

Mr. HEASLIP. Help to narrow this more—focuses more narrowly on very senior executives, which I believe was its intent.

Ms. TUBBS JONES. Mr. Bentsen, again, I have been coming and going, so I apologize. This seems to be the day that every constituent in my congressional district wanted to see me at this hour.

Stick for a moment about the ILOs. Even though they are no longer taking place, there are existing ones that still have time to run their course. What would you propose that we would do with regard to them?

Mr. BENTSEN. Good question, Congresswoman. There are such transactions in place. Those that are—and there are some that have been questioned by the IRS. The bottom line is that, as Congress intended by establishing the tax courts and the whole process of it, the transactions that the Service feels are questionable or should be challenged, are in fact, being challenged.

So, the process itself is working. If, in fact, the service prevails in that challenge to record or direct negotiations, then the Government and the taxpayers, as a whole, will get their due.

What this provision would do—would do, really, two things. One, it would impose this retroactive tax on every type of transaction, whether they were challenged or not. So, it's a very blunt instrument, in that regard.

Second, it really would tilt—it would undermine the due process rights of taxpayers that is a basic standard and right in this country, and would tilt the balance in the favor of the Government.

The proponents have made the argument—perhaps well-intentioned, but I think faulty—in saying, "Well, this would relieve the Service of having to bring suit. In fact, we believe the Service is going to win all these cases." Well, they haven't won any cases yet. There have been no judgements rendered.

Again, I don't think it's appropriate to intervene at this point on the assumption that something is going to happen that has not yet happened, and to deny a taxpayer their day in court. If, in fact, the Government proves their case, then, as I said, the Government will get its due.

Ms. TUBBS JONES. I thank you for your answer. To the other gentleman, I have run out of time. I had questions for you, but the Chairman is running a close clock. Thank you, Mr. Chairman.

Chairman RANGEL. Mr. Pascrell.

Mr. PASCRELL. Thank you, Mr. Chairman. Sorry I had to duck out for another meeting. I know some of these things have been touched, but I would like to ask the panel your reaction to what I have to say.

I have deep reservations about the Senate's version of deferred compensation, I really do. It hurts too many people, and we should be targeting those that are greedy, instead of looking at the entire—I respect the attempt made by the Senate to limit the levels of compensation of senior officials who can electively defer, in an effort to avoid paying taxes. What that number is, is quite interesting.

I have a couple of concerns. First, the Senate provision is retroactive. I believe wholeheartedly that it is the duty of Congress to remedy laws that are potentially being abused. I believe it is often inherently unfair to go back in time and penalize individuals for actions taken at a time when the law was permissive of a particular activity.

I think this Committee needs to ensure that any restrictions that may be adopted will be completely prospective. I think that it should be a general rule that any action we take, regardless of what specific section we're talking about, will in no way, shape, or form, apply to any prior actions, including prior deferrals. That's my opinion. Or, decisions taken prior to the date of the enactment. I hope you agree with that.

I am also concerned about the overly broad applications the Senate provision would entail. There are many legitimate uses for deferred compensations, including employee retention, the alignment of shareholder/employee/employer interests. I would hate to see these programs lose their effectiveness because the congress was not precise, as well as incisiveness in shaping and drafting the legislation.

I would like to work to ensure that if some form of the Senate's provision is included in the final small business tax package, that it be carefully crafted to affect only its intended targets. I would like your quick responses to that, please.

Mr. PETRINI. Mr. Pascrell, I have to respectfully disagree with one premise that you started with—actually, two parts of it.

One is the provision should only affect the greedy, because I don't think that deferred compensation has anything to do with greed, but let me explain. When we're talking deferred compensation here, the issue of how much an executive should be paid, I don't think that is an issue where the issue of greed comes in.

Let's assume that it's been decided that the executive is going to be paid $10 million a year, and we can agree whether or not that is greedy. If that executive is going to be paid $10 million a year in cash, versus being paid $1 million in cash and $9 million deferred, there is no greed involved in deferring that $9 million.

In fact, I think the shareholders are much better served by the fact that instead of this person taking $10 million of cash out of the company today, he has actually left $9 million at risk. The other part of that——

Mr. PASCRELL. Just to respond to that——

Mr. PETRINI. Sure.

Mr. PASCRELL. I am talking about those folks who are at the top of the ladder. I am not talking about middle management. Those people have been caught up—or would be caught up—if that legislation passed.

Mr. PETRINI. No, I'm talking about an executive who would make $10 million, otherwise.

Mr. PASCRELL. All right.

Mr. PETRINI. I think we should encourage him to defer as much of that $10 million as possible. I think it's a totally different issue, how much he should be paid, but whatever he is being paid, we should ask him to defer as much as possible.

Mr. PASCRELL. I agree, I agree, I agree.

Mr. PETRINI. The other issue is there is no tax avoidance involved in deferred compensation, because non-qualified deferred compensation perfectly follows the matching principle. The executive is not taxed until he receives the money, the company does not get the corporate tax deduction until it is paid. It is perfect matching, there is no tax avoidance involved. There is tax deferral.

In fact, the way the system works, the company has to give up its deduction. It's the same as if the company had borrowed money from the executive. So, there is really no tax avoidance here.

That's the issue I have tried to make a few times today, is that executive deferred compensation, whatever you believe executives should be paid, having them defer compensation is good. It's good for aligning their interests with those of the shareholders, because if they run that company into the ground, they get none of that. It's consistent with what you enacted in section 409A, which basically requires key employees to leave their money at risk of the company, and avoids cut and run type of things on the pass.

So, I would actually urge a lot more thought on whether deferred compensation is bad, even for those who make a real lot of money.

Mr. PASCRELL. I did not say, nor did I imply, that deferred compensation, in and of itself, is inherently bad. That I did not say, did not infer. So, I listen to what you're telling me, but I didn't say that.

I am concerned about fairness, and I am concerned about what goes into the tax revenue, what goes into revenue, what does not go into revenue. If you defer the tax, you are not—at the time, we may need that in the revenue cycle.

Mr. PETRINI. Remember, if the executive defers his tax, the company is also deferring its deduction. So, other than the difference between the executive's rate and the corporate rate, which currently is not all that great, there is no real loss of revenue, just because the income has been deferred, since a deduction is also being deferred.

Mr. PASCRELL. Thank you.

Chairman RANGEL. The gentleman from California is recognized for questions, Mr. Becerra.

Mr. BECERRA. Thank you, Mr. Chairman, and thank you to the four of you for your testimony. Mr. Heaslip, let me ask you a couple of questions. Deferred compensation has become an issue over the last few years, especially with regard to CEOs. You make some good points. I think you are trying to say, "Be careful how you move on this, because it could have an impact far beyond just a CEO."

You also—very quickly, because you were running out of time—had some potential recommendations, if we were to try to consider acting on this. I'm wondering if you can give me a sense of, not just with regard to the specific proposals that were included in the Senate, but just generally, some guideposts that you might want to offer us as we continue to examine deferred compensation, because I think you made a very good point about how the consequences of what we could do—and if I could quote you directly, I think you mentioned that the potential impact could affect things like retirement security, personal savings, competitiveness, and shareholder interest. I think you're right about that.

So, give me a more broad answer to the general question of this issue of deferred compensation, obviously with a focus on what the Senate did, but just, generally, some guideposts.

Mr. HEASLIP. Sure. We agree that executive compensation is kind of one of the most important aspects of good corporate governance. I think to the conversation that just took place, I would like to make a distinction between how much we pay executives and how we pay executives.

I think the broader issue is how much we pay executives that is being addressed or swept up into this discussion about deferred compensation, which is more about how we pay them and when we pay them.

In my opinion, if you want to get at the issue of executive compensation, we should be looking at governance, shareholder advocacy, disclosure, and transparency in our compensation practices. We shouldn't be focusing on tax legislation.

If, however, for political or substantive reasons, it is felt necessary to take a look at the rules surrounding deferred compensation, and further regulations are necessary, we think we do need to narrow the focus to CEOs or named executive officers. We think a uniform cap would be more appropriate than the very broad-based one-time earnings test that is currently proposed.

We would exclude broad-based restoration plans that simply provide the benefits that other employees are entitled to. We would exclude elective deferral programs for the kinds of reasons that Mr. Petrini has outlined, in connection with the revenue neutrality. Kind of the additional incentive to perform, in the interest of shareholders.

Mr. BECERRA. I appreciate that. I wanted to say welcome to former Member and colleague, Mr. Bentsen, for being here. We thank you for your testimony. Hopefully, this will help us shape something that may come out of conference that does address the various concerns that you have all raised. So, thank you very much.

Mr. LEWIS OF GEORGIA [presiding]. Well, thank you very much. The gentleman from North Dakota, Mr. Pomeroy, is recognized for questioning.

Mr. POMEROY. Thank the Chair. I will start with acknowledging my friend and former colleague, Mr. Bentsen. We still miss you. Bentsen is known as having made a significant contribution in the Senate. Maybe less known, but still known to many of us who worked with you. You served with great distinction in the House, too. That's a good name, that Bentsen.

Mr. Heaslip, I want to talk to you about pensions, generally. I appreciated your testimony, in terms of the deferred compensation issue, but in a broader context of employee benefits.

You indicate that the PepsiCo pension is well funded. How, in fact, has it been doing in recent years, in light of an improving stock market, relatively strong interest rate environment, what is the funding level?

Mr. HEASLIP. Yes, it's been a rough ride over the past 5 years. As you know, we had poor equity returns in the early 2000s, interest rates have been low, which have increased liabilities, and we are fortunate to have a growing, thriving company that has allowed

us to fund the plan over this period of time. Not all companies have been able to do that.

Over the past 5 years, we have contributed about $2.4 billion to our pension plan in order to retain its health and funded status. As a result, we are currently at about 105 percent of liabilities, which obviously provides security to our existing——

Mr. POMEROY. I think that that's excellent. I think that there was a misperception, promoted by the Department of Labor, that this rough ride you speak of was a bumpy road toward a system-wide failure, in terms of private sector pensions.

Recently, the Wall Street Journal reported that the Fortune 100 are, on average, 102 percent funded, and that the recovery of the stock market—because that's bouncing around a little these days—but fundamentally looks strong, and the sustained interest rate environment have substantially improved the long-term outlook for pension plan funding, even before the Pension Act passed by Congress last year takes effect. Is that your read?

Mr. HEASLIP. All of those are beneficial to defined benefit plans.

Mr. POMEROY. I am very concerned that the increase funding requirements passed in the bill are going to lead toward a slew of actions freezing pension programs.

Do you have an evaluation of that, and what are PepsiCo's plans?

Mr. HEASLIP. We are going to continue to monitor our industry and the marketplace. We did a very thorough pension review last year. We concluded that the plan is appropriate for our workforce. We are trying to encourage people to spend a career with PepsiCo, have valuable industry and customer knowledge that we want to retain in our workforce.

We are not interested in them working for us for 5 years or 10 years, and then going to a competitor. A plan is a very effective means of encouraging people to spend their career at PepsiCo. At the same time, we have to be competitive in the marketplace, and we have to make sure we monitor what our industry is doing, and what our peer companies are doing. We have to maintain flexibility to make changes, if necessary, to stay competitive.

I don't know that there is any one thing that are going to drive these plans out of business. When I look at the amalgamation of financial challenges, the types of challenges that are presented by this legislation in combination, it does generate concerns about the future health of the system.

Mr. POMEROY. I will get to this legislation. Just one moment, one final question, first, and that would be the importance of lifelong income, as provided by a pension. It's 70 to 80 percent, I believe you indicated, income replacement, and guaranteed, then, over the lifetime the retired employee will have in retirement, that, to me, is a very optimal benefit for someone in the workforce, worrying about what they're going to do in retirement years.

The—given your expertise, do you see anything—have you been able to—have you perceived, either from Congress or the Department of Labor, or anywhere else in the Administration, support for your efforts to continue pensions?

Mr. HEASLIP. I think, from a policy standpoint, it's very clear that Congress would like to see continuation of the defined benefit system, but from time to time, we get conflicting signals.

Mr. POMEROY. My own thought is that we are still—we are protecting people right out of their pensions by putting onerous funding requirements that are not necessarily reflective of today's long-term solvency picture, and that we're going to pressure companies.

One final issue—and this is the last question I would have for you—if you take the deferred comp provision of the Senate, and so that you would look at a provision where your upper management, those making the decisions on whether to retain the pension or not, would get a similar income replacement than the rest of the workforce.

Wouldn't it further disincent PepsiCo and other companies to continue pensions for employees?

Mr. HEASLIP. I think that is one highly likely outcome from this legislation. If you disenfranchise middle and senior managers, I believe it could throw these types of plans at risk for all employees.

Mr. POMEROY. My own thought, Mr. Chairman, is that we need to send a very clear and unequivocal signal that pensions for the 20 million workers who have them are vitally important, and we want to help companies keep them in place. I thank the gentleman for his testimony. Thank you, Mr. Chairman.

Mr. LEWIS OF GEORGIA. Thank you, the gentleman from North Dakota, for his comments. The Chair will recognize the gentleman from New York, Mr. Crowley, for questioning.

Mr. CROWLEY. Thank you, Mr. Chairman. Thank you to the gentlemen, for their testimony today. I know time is of the essence, we have a number of votes before us, so I will just state that I don't have a question for the panel, but I do want to make a statement into the record, and direct that statement to you, Mr. Chairman.

I have deep reservations about the Senate deferred compensation provision. While I respect the attempt made by the Senate to limit the levels of compensation, and a senior official can electively defer in an intent or an effort to avoid the payment of taxes, I have several fundamental concerns, some of which have already been expressed already.

Second, the provision is retroactive. While I believe it is the duty of Congress to remedy laws that are potentially being abused, I believe it is inherently unfair to go back in time and penalize individuals for actions taken at a time when the law was permissive of a particular activity.

Mr. Chairman, I am also concerned about the overly broad application the Senate provision would entail. There are many legitimate uses for deferred compensation programs, including employee retention, and the alignment of shareholder and employee/employer interests. I would hate to see these programs lose their effectiveness because the congress was not precise in its drafting of its legislation.

Mr. Chairman, I would like to work with you to ensure that if some form of the Senate provision is included in the final small business tax package, that it be carefully drafted to affect only its intended targets.

Mr. Chairman, I would like to work with you to ensure that taxpayers are not subject to the retroactive provisions of the bill in section 162(M), executive compensation that exceeds $1 million, or annual non-qualified compensation. Now, Mr. Chairman, I hope to work and cooperate with you in those efforts, and I hope to have your acknowledgment of that.

Mr. LEWIS OF GEORGIA. Let me thank the gentleman for the comments, and thank each member of the panel for participating and for being here today. I think your testimony has been quite helpful, more than helpful.

Mr. CROWLEY. Thank you, Mr. Chairman. I would like to give a special hello to a former colleague, as well as one of New York State's greatest companies, PepsiCo, for testifying today.

Mr. LEWIS OF GEORGIA. I believe the record will stay open for 14 days, for any Members who may have comments to issue. Thank you for being here.

Chairman RANGEL. [presiding] Let me join in thanking this panel for your knowledge and your patience. Thank you very much.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the American Bankers Association

Mr. Chairman and members of the Committee, this statement is being submitted for the record by the American Bankers Association ("ABA"). ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The ABA appreciates the opportunity to submit this statement for the record regarding the Small Business and Work Opportunity Act of 2007, H.R. 2. We are troubled by three revenue raising provisions (Sections 206, 214, and 201) that have been included in the bill by the Senate, and are particularly concerned that they tax businesses retroactively.

Retroactive tax policy is bad tax policy. America's business community must be able to depend on the certainty of the law in order to make informed business decisions. Enacting retroactive tax policy completely changes the economics of those past decisions and could result in excessive and arbitrary costs. Moreover, it adds to the risk and uncertainty of any business decision and could force businesses to delay or shun decisions for fear that later changes in the law will render such decisions illegal or financially burdensome, or both. Hence, retroactive changes to tax law should be avoided. The ABA, therefore, urges this Committee to remove these sections from the bill.

In this statement, the ABA wishes to express our concerns regarding the three revenue raising provisions embodied in H.R. 2:

- **Congress should not impose an arbitrary limit on income that can be deferred under non-qualified deferred compensation plans, particularly since recent changes in law affecting these plans have yet to be implemented and the consequences of those previous changes are unknown. (Sec. 206)**
- **Expanding the definition of "covered employees" would *retroactively* tax deferred compensation amounts even though decisions about these amounts have been made under existing law for many years. (Sec. 214)**
- **Changing the effective date for SILO transactions will result in a retroactive tax increase on banks. (Sec. 201)**

Each of these concerns will be addressed below.

I. Limitation of Deferrals for Non-Qualified Deferred Compensation is Inappropriate

The bill seeks to limit the aggregate amount of executive compensation that can be deferred under Internal Revenue Code Section 409A. Under that section, deductibility of deferred compensation is limited to $1 million or the average annual compensation over five years, whichever is lesser. Furthermore, this provision is made applicable to deferred compensation plans for all employees, not simply to deferred compensation for senior executives.

However, many employers offer deferred compensation plans to middle management and other non-executive employees as a way to create incentives, reward hard work, and retain valuable employees. If the provision in question is enacted, it will create an arbitrary limit on deferred compensation plans, which in turn would reduce the overall compensation of the employee. Moreover, many employees find these plans provide additional resources for retirement. Thus, arbitary restrictions would put a greater strain on the ability to save for retirement for these individuals. Additionally, deferred compensation plans that are already in existence will become subject to this provision. This has the potential of punishing employees and employers for compensation agreements reached long before this provision was considered.

It should also be noted that Congress recently changed the rules for non-qualified deferred compensation arrangements when it enacted the Pension Protection Act of 2006. The Department of the Treasury ("Treasury") was directed to promulgate regulations implementing these changes, but it has not yet finalized its rules. We believe that it is inappropriate for Congress to make further changes to the law concerning deferred compensation arrangements, when the impact of previous changes in this law are still unknown. Prior to any further changes to the law governing non-qualified deferred compensation plans, employers and Congress should be afforded time to study the rules promulgated by Treasury (once finalized) in order to understand and evaluate their impact.

II. Expanding the Definition of "Covered Employees" Will Result in Retroactive Taxation

As passed by the Senate, H.R. 2 expands the definition of "covered employees" in an effort to limit the amount of executive compensation that publicly-held companies can deduct from their taxes. Under existing law, both the CEO of a publicly-held company, and the four officers with the highest compensation levels, are considered "covered employees." Any compensation that "covered employees" receive that is in excess of $1 million is not tax deductible by the company.

H.R. 2 expands the definition of "covered employee" to include any employee that was a "covered employee" for any preceding taxable year beginning after December 31, 2006. The language of the provision indicates that it is applicable only to executives that are subject to reporting after 2006. However, this does *not* mean that the tax burden is limited to compensation after 2006. In fact, the provision captures the full amount of deferred compensation from all prior years for "covered employees" that the employer is contractually obligated to fulfill. This represents a significant problem for deferred compensation plans designed to accommodate executives that are currently considered "covered employees."

As an example, consider the case of senior executives of a bank who have been covered employees for several years and have received deferred compensation in the form of company stock. Over time, the price of the stock received has appreciated and the value of their account has grown substantially. Under the deferred compensation plan created many years earlier, the bank expected that it would be able to pay the deferred amounts upon retirement or termination of the executives. Since the executives would no longer be considered "covered employees," the bank would then be able to deduct this expense.

However, the provision in H.R. 2 will result in the bank losing its ability to deduct those previously deferred amounts. This in turn will increase the bank's tax liability by millions of dollars, resulting in a retroactive tax increase.

A retroactive tax increase of this nature will punish businesses for legitimate decisions that were based on the certainty of existing tax law. It will also create great uncertainty and risk with respect to future issues of compensation. Businesses should be able to continue to rely on the certainty of the law and any restrictions imposed should apply prospectively only.

III. Changing the Effective Date for SILO Transactions Results in Retroactive Taxation

The proposed changes to the effective date for leasing provisions under the American Jobs Creation Act ("AJCA") of 2004 are also of concern. With the passage of the AJCA, Congress enacted limitations on the deductibility of losses from future

sale-in/lease-out ("SILO") transactions. Effective March 14, 2004, deductions from property leased to a tax-exempt entity were limited to the taxpayer's gross income generated from the lease for that tax year. Significantly, Congress made clear at the time that this change to the tax law would be applied only on a prospective basis.

Prior to the passage of the AJCA, several issues impacting the effective date of the new provisions were debated. These included: (1) the fact that most transactions had been based on long-standing tax law; (2) that several transactions were in mid-stream and a loss of tax benefits would have negatively impacted them financially; and (3) that the effective date for any such change in the law should be prospective. As a result of these considerations, the final version of AJCA included appropriate grandfathering for transactions entered into before March 12, 2004.

Now, three years later, the Senate is attempting to change the effective date. If enacted, the net effect will be a retroactive tax increase on banks, punishing them for entering into transactions that were, in some cases, crafted many years ago.

We would like to thank the committee for holding this hearing and giving us the opportunity to comment. Additionally, we look forward to working with you on these and other issues during the 110th Congress.

Statement of the American Bar Association Section of Taxation

This statement is submitted on behalf of the Section of Taxation of the American Bar Association. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the policy of the American Bar Association.

The Section of Taxation appreciates the opportunity to provide input to the Committee on Ways and Means (the "Committee") on the revenue increase measures in the "Small Business and Work Opportunity Act of 2007"—the Senate-passed version of H.R. 2 (the "Bill"). Our comments address the limit on the amount of annual deferrals under nonqualified deferred compensation plans that would be added to section 409A [1] by section 206 of the Bill.

We have followed these provisions with interest since they were first proposed. On February 2, 2007, we wrote a letter to Chairman Baucus and Senator Grassley of the Senate Finance Committee on behalf of the American Bar Association expressing concern about the inclusion of provisions in the Bill without the benefit of public hearings or public comment. On February 7, 2007, we wrote a letter to Chairman Rangel and Congressman McCrery of this Committee also urging that proposed amendments to the tax laws, such as these, be exposed for public comment, preferably through hearings, before Committee action. We, therefore, commend the Committee for holding hearings on the revenue increase measures in the Bill, and hope that our comments below will be useful in the Committee's deliberations.

We believe that these provisions would impose enormous and disproportionate (relative to the abuses they are designed to correct) administrative burdens on taxpayers, their advisers, employers and others. We previously urged the leadership of the tax-writing committees "to hold comprehensive hearings and otherwise gather information about the potential impact of [section 409A], including the estimated costs of compliance." [2] At that time, we explained the important policy reasons for conducting a thorough review of section 409A prior to the law becoming fully effective, which is now scheduled for January 1, 2008. We continue to urge that the Committee hold such hearings.

Limit on amount of annual deferrals under nonqualified deferred compensation plans

Section 206 of the Bill would amend section 409A to require nonqualified deferred compensation plans subject to that section to limit an individual employee's annual deferrals to the lesser of $1 million or the employee's average taxable compensation over the previous five years. Earnings on previous deferrals would be treated as additional deferrals for this purpose, and all nonqualified deferred compensation plans of the same employer would be aggregated. Failure to comply with the limit would

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] Letter dated July 31, 2006, from the ABA Section of Taxation to William M. Thomas, Chairman, House Committee on Ways and Means, Charles B. Rangel, Ranking Member, House Committee on Ways and Means, Charles E. Grassley, Chairman, Senate Committee on Finance, and Max S. Baucus, Ranking Member, Senate Committee on Finance.

trigger penalty taxes and interest under section 409A. The $1 million limit would not be indexed for inflation.

Rationale for new limitations. We have a number of concerns about the proposal. To begin with, we question several of the premises on which it is based. The Finance Committee's report on the Bill states that:

The Committee is concerned with the large amount of executive compensation that is deferred in order to avoid the payment of income taxes. Rank and file employees generally do not have the opportunity to defer taxation on otherwise includible income in excess of the qualified plan limits. However, it is common for nonqualified deferred compensation arrangements to allow executives to choose the amount of income inclusion they wish to defer. [footnote omitted] The Committee is concerned that the ability to defer unlimited amounts of compensation gives executives more control over the timing of income inclusion than rank and file employees. S. REP. No. 110-____ at 58–59 (2007).

We respectfully disagree with the suggestion in the first sentence that executive compensation is deferred primarily to avoid the payment of income taxes. In our experience, executives defer compensation for the same principal reason that rank-and-file employees do, namely to save for retirement. This is a worthy goal regardless of an employee's income level. We also disagree with the implicit assumption that deferring compensation in a nonqualified deferred compensation plan reduces tax revenues. Section 404 prohibits a taxable employer from deducting nonqualified deferred compensation until it is included in the employee's gross income.[3] Income earned on the deferrals is taxable to the employer. Thus, the net revenue effect of such deferrals is close to zero.

Furthermore, based on our experiences, the suggestion in the remainder of the paragraph that rank-and-file employees have much more limited deferral opportunities than executives because they only participate in the employer's tax-qualified plans ignores several important points:

- Differences in deferral opportunities are more likely to reflect the structure of the Employee Retirement Income Security Act ("ERISA") than any kind of income-based discrimination. Any enhanced deferral opportunities that executives have must be provided under a nonqualified deferred compensation plan. Under ERISA, employees who are not part of a "select group of management or highly compensated employees" (often called a "top-hat" group) generally may not participate in a deferred compensation plan which defers compensation to termination of employment or later unless the plan is funded, and a nonqualified deferred compensation plan that is funded is no longer able to defer taxes. Thus, for the most part ERISA effectively prohibits rank and file employees from participating in nonqualified deferred compensation plans.
- Tax-qualified plans provide as much opportunity to save for retirement as many rank-and-file employees are willing or able to use. It is unusual for rank-and-file employees to make elective contributions up to the current dollar limit ($15,500, or $20,500 if the employee is 50 or over and the plan permits catch-up contributions). Also, nonelective and matching contributions, and accruals under pension plans, are subject to much higher limits. Congress may want to examine ways to increase deferral opportunities—and retirement savings generally—for rank-and-file employees who are interested in saving more. We strongly support such consideration. We do, however, question the purported constraints imposed by the existing rules.
- A large percentage of nonqualified deferred compensation is provided under supplemental retirement plans ("SERPs") or benefit equalization plans ("BEPs")—plans designed to provide the benefits that the executives would have received under the employer's tax-qualified plans but for the Code-imposed limits on compensation, contributions and benefits that apply to those plans. SERPs and BEPs, by their nature, replicate the benefits and limitations (other than the statutory limitations) that are imposed in the underlying tax-qualified plans. For example, if the underlying tax-qualified plan provides for an em-

[3] This creates a "tax tension" between a taxable employer and an employee who want to defer compensation. There is no such tension in the case of a nontaxable employer. That is the main reason that has been given for imposing a dollar limit (currently $15,500) on annual deferrals under nonqualified deferred compensation plans maintained by governmental and tax-exempt employers. *See* Code § 457(b). "In contrast," according to the Department of the Treasury, "*such limitations are not necessary for private, taxable employers* because the tax tension between the employers' preference for a current deduction and the employees' incentive for deferral will provide inherent restraints on the amount of deferred compensation that is provided." Department of the Treasury, *Report to The Congress on The Tax Treatment of Deferred Compensation Under Section 457*, at 10 (Jan. 1992) (emphasis added).

ployer contribution of 6% of compensation up to the $225,000 limit under section 401(a)(17), a SERP might provide a credit of 6% on compensation over $225,000. Participants in such plans do not really have more opportunities to defer compensation: they simply have more compensation to defer and can only do so in a nonqualified plan, because of the way that ERISA is structured.[4] Congress may be concerned when executives have much higher compensation than rank-and-file employees, but that issue is a general economic matter, not a structural problem with the existing tax system.

The foregoing observations are based on our extensive experience with employee benefit matters. There is, however, sparse data on nonqualified deferred compensation.[5] In part because of the absence of data, we believe Congress should proceed carefully in this area, after gathering as much information as possible through public hearings and other means.

Scope of limit. We think the scope of the limit goes beyond even what is required by the stated rationale. First, the passage quoted above suggests that the Finance Committee was concerned primarily or exclusively with elective deferrals, not retirement savings generally. However, the limitation is not restricted to elective deferrals. To the contrary, it appears to apply to any amounts that would be considered deferred compensation under section 409A and the regulations under that section. That section covers a wide range of nonelective arrangements, including, for example, SERPs and BEPs that supplement benefits under traditional defined benefit pension plans. Many companies also have automatic deferrals of annual or long-term bonuses to which section 409A applies, as well.

Second, Senator Grassley's floor statements suggest that the Senate thought the limit would apply mostly to "the wealthiest [individuals]—*i.e.*, those individuals receiving more than $1 million annually in nonqualified deferrals."[6] In practice, however, the new limitation will apply to many other employees. The limit by its terms is the lower of $1 million or the employee's average taxable compensation over the past 5 years. Thus, it is certain to apply to some middle-management employees deferring much less than $1 million. It also treats earnings on previous deferrals as additional deferrals. Thus, even without the 5-year look-back rule it could apply to middle-management employees with substantial account balances and earnings who defer relatively little from their current compensation.

In his floor statements, Senator Grassley did not dispute this. Instead he said the Joint Committee on Taxation had estimated that eliminating the five-year look-back rule would reduce the revenue score by less than $100 million out of $806 million, and that this suggested that only about 10% of the individuals affected by the limit were deferring less than $1 million. However, since the revenue estimates are based on deferrals, this actually suggests that middle management will make up more—perhaps much more—than 10% of the affected group on a headcount basis.[7] Senator Grassley also said that including middle management in nonqualified deferred compensation plans "raises other red flags"—suggesting, perhaps, that it does not or should not occur. We agree that not all individuals in middle management are part of the "top-hat" group that can participate in nonqualified deferred compensation plans. However, this group can be relatively large,[8] there are no clear guidelines, and in our experience most employers try to cover as many individuals as they are allowed to cover.

Third, a violation will occur any time an individual's deferrals (plus earnings on previous deferrals) exceed the limit in any given year. For this purpose, all nonqualified plans (not just plans of the same type) would need to be aggregated. Nonelective deferrals, and earnings on previous deferrals, can be very uneven and difficult to value or predict. If deferrals are not counted against the limit until they

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[4] As noted above, amounts deferred under nonqualified plans do not generate current tax deductions for the employer, and income attributable to deferred amounts is taxed to the employer during the deferral period. Also, participants in such plans have far fewer protections than they would under a tax-qualified plan. For example, amounts set aside to provide benefits are subject to the claims of the company's creditors in bankruptcy.

[5] At the same time that it enacted section 409A, Congress added a requirement to report the amount deferred under a nonqualified deferred compensation plan on Form W–2. However, that requirement is not yet in effect, partly because the IRS has recognized how hard it is to value those amounts.

[6] See 153 Cong. Rec. S1492 (daily ed. Feb. 1, 2006) (statement of Sen. Grassley).

[7] For example, if three executives earned $200,000 each and deferred half of that amount under a nonqualified deferred compensation plan, and one executive earned $5.4 million and deferred half of that amount under the same plan, the first three executives would defer 10% of the total amount deferred under the plan, but make up 75% of the plan participants.

[8] See, e.g., Gallione v. Flaherty, 70 F.3d 724, 729 (2d Cir. 1995) (group consisting of all full-time officers of union was sufficiently select even though it included over 25% of employees).

vest, this problem is exacerbated and applies to elective deferrals as well. Thus, even individuals whose regular deferrals (plus earnings) are much less than the limit will, on occasion, have excess deferrals which will have to be forfeited or corrected in some fashion.

Fourth, this type of limitation tends to favor new hires over long term employees whose compensation is averaged over a longer period. It tends to treat similarly situated employees differently based on quirks on their compensation histories, such as option exercises which would increase compensation in the particular year of exercise. It also tends to disfavor employees at companies such as start-ups with relatively low levels of cash compensation.

Practical difficulties implementing limit. We also think that the limit, as currently drafted, will be difficult to implement—both by employers and by the Internal Revenue Service (the "IRS")—and is likely to have unexpected and unfair consequences. As noted above, nonelective deferrals, and earnings on previous deferrals, can be uneven and difficult to value or predict. For example, benefits under non-account balance (defined benefit) plans, especially those that are integrated with Social Security or that provide early-retirement subsidies; equity-based plans that are treated as deferred compensation under section 409A; and post-termination benefit continuations, are particularly difficult to value as they accrue. In order to apply the limit to such plans, the IRS will have to prepare elaborate valuation guidance and train its auditors on how to apply it, which will require substantial tax administrative resources. If it does not, it might prove difficult for the IRS to challenge taxpayers' actuarial valuations.[9]

One alternative would be to wait to value deferrals until they are "reasonably ascertainable.". That is what the regulations provide under section 3121(v), which subjects deferred compensation to FICA taxes when they accrue or vest, whichever is later. However, this would tend to bunch up deferrals in a single year and substantially increase the chances of violating the limit.

It might also be appealing to count deferrals against the limit only when they vest, since it seems unfair to treat a plan as violating the limit and trigger penalties taxes because of benefits that an employee might never receive. That is the way the dollar limit in section 457(b) is applied. However, this, too, would tend to bunch up deferrals in a single year and substantially increase the chances of violating the limit.

Finally, treating earnings on previous deferrals as additional deferrals will punish employees whose deemed investments do well, and will make it progressively harder for a long-service employee to avoid the limit as his or her account—and the earnings on that account—grow over time. This is likely to be perceived as unfair and even age-discriminatory.

It has taken the IRS over two years to draft final regulations on the major provisions of section 409A, and, according to an IRS official, when those regulations are issued they will be "voluminous."[10] To address concerns like those noted above, we think that regulations implementing the proposed limit are likely to take just as long to draft and be just as voluminous.

Effective date issue. It is unclear whether the limit will apply to amounts deferred on or before December 31, 2006, if they vest after that date. For purposes of the effective date of the original section 409A, which used nearly identical language, amounts were not considered deferred until they vested. Taking this approach under the proposed limit would subject an even larger amount of deferred compensation to the limit. Furthermore, it is unclear how the limit would apply to existing deferrals. Applying it to existing deferrals when they vested would create the bunching problem noted above. Applying it retroactively to the years in which the deferrals occurred would, in our view, be unfair to taxpayers who relied in good faith on prior law.

Effect on defined benefit plans. We think the limit, as currently drafted, could indirectly discourage employers from maintaining tax-qualified defined benefit plans. That is because, as noted above, in our experience a large percentage of nonqualified deferred compensation is provided under SERPs and BEPs that provide benefits that would have been received under the employer's tax-qualified plans but for various statutory limits, and benefits under SERPs and BEPs that supplement defined benefit plans will be the most difficult to predict and value under the proposed limit. This will impose one more burden on employers that still maintain those plans, and add to the reasons they have for freezing or terminating them.

[9] See, e.g., Wells Fargo & Company v. Commissioner, 120 T.C. 69 (2003); Vinson & Elkins v. Commissioner, 99 T.C. 9 (1992).
[10] Daily Report for Executives, No. 41, at G–4 (Friday March 2, 2007).

Composition of deferred compensation. If the proposal is enacted, it will inevitably reduce certain types of deferred compensation. Our experience suggests, however, that total compensation will not be significantly affected. This is borne out by experience after the enactment of sections 280G and 162(m), and is likely to be the result here as well. Instead, the new law may be expected to induce distortions in executive pay, many of which will be undesirable for non-tax reasons. For example, current cash compensation may increase, thereby reducing the employee's interest in the long-term prospects of the employer. Alternatively, greater emphasis may be placed on various types of equity-based compensation that are not subject to the proposal. This may cause over-utilization of stock options and restricted stock. Any such changes may have significant ramifications for executive compensation and corporate governance in general.

Conclusion

Fundamentally, we think that publicity and the activism of shareholders and unions are more appropriate mechanisms for counterbalancing excess executive compensation than one-size-fits-all limits imposed by the Code. While certain CEO severance packages have received a great deal of press recently, such arrangements have also gotten the attention of shareholder activists.[11] Furthermore, a number of public companies have taken steps on their own following the highly publicized—and criticized—large severance packages for the Home Depot and Pfizer CEOs. For example, Waste Management, Inc., Marathon Oil Corporation and Wachovia Corporation have all published in SEC filings that they have policies regarding when the Board must seek shareholder approval of an executive officer's severance package when it exceeds certain specified limits. These trends are likely to continue as a result of the enhanced SEC disclosure requirements for executive compensation which went into effect this year.

We would like to thank the Committee for the opportunity to express our views on the executive compensation provisions in the Senate-passed version of H.R. 2. We believe that, especially as currently drafted, they are unlikely to achieve the purpose for which they are intended; will unnecessarily complicate the Code and burden the IRS; may harm many middle-management employees; and may well induce serious adverse consequences outside of the tax system. By discouraging SERPs and BEPs that supplement benefits under tax-qualified defined benefit plans, the limit on annual deferrals could even end up hurting the rank-and-file employees that it is intended to benefit.

Statement of American Benefits Council

The American Benefits Council submits this statement in connection with the hearing of the House Committee on Ways and Means on the Small Business and Work Opportunity Act of 2007 (the "Act"). We respectfully request that this statement be included in the record of the hearing.

Our comments address two revenue raising provisions included in the Act: (i) Section 226, which expands Internal Revenue Code section 409A to impose dollar caps on nonqualified deferred compensation plans, including all earnings under those plans, equal to the lesser of "one times pay" or $1 million; and (ii) Section 234, which expands Internal Revenue Code section 162(m) to deny employer deductions for certain compensation payments to both current and former top executives of publicly-held companies, including payments that are already scheduled to be made under legally binding contracts.

The American Benefits Council is a public policy organization representing more than 250 members that are primarily major U.S. businesses providing employee benefits to active and retired workers. The Council's members do business in most, if not all, of the states. The Council's membership also includes organizations that provide employee benefit services to employers of all sizes. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The Council's members have raised significant concerns about both the policy and practical effects of sections 226 and 234 in the Act. We believe that both of these revenue raising provisions are significantly flawed and we urge that they be rejected.

[11] See Joann S. Lublin and Phred Dvorak, *How Five New Players Aid Movement to Limit CEO Pay,* Wall St. J., March 13, 2007, at A1.

Section 226—Dollar Caps on Nonqualified Deferred Compensation

Section 226 would amend Code section 409A to impose a dollar cap on nonqualified deferred compensation that is the lesser of $1 million or "one times pay" for an employee. The penalty for exceeding this dollar cap is immediate income inclusion of the total nonqualified deferred compensation earned by the employee plus a 20-percent addition to tax and interest. The Council has serious concerns with this provision because it would impose arbitrary limits on deferred compensation plans and impose draconian tax penalties if those limits are exceeded. The dollar cap is not limited to the pay packages of senior executives. If enacted, the dollar cap in Section 226 would apply to any arrangement that falls within the technical definition of a "nonqualified deferred compensation plan" under Code section 409A. These include non-elective plans, such as retirement-type and supplemental pension plans, incentive compensation, and certain equity arrangements, such as restricted stock units and stock appreciation rights that do not squarely fit within the current regulatory exceptions under section 409A.

Although section 226 of the Act may have been viewed as addressing perceived problems with "executive" pay, the broad spectrum of plans that would be subjected to the dollar cap lead us to conclude that middle management employees likely would see the most drastic changes in their benefit programs should section 226 be enacted. The uncertainties and administrative burdens created by a dollar cap may discourage some employers from providing such programs for middle-management, many of which are designed to complement the employer's tax-qualified retirement plans by allowing employees to save for retirement on their total compensation. We have attached to our statement a number of examples taken from companies, which illustrate the scope of the dollar cap.

Moreover, the effect of the dollar cap included in section 226 of the Act would be to subject nonqualified plan dollars to income inclusion and a potential 20-percent addition to tax before funds are actually paid or made available to an employee. This is a fundamental and, in our view, unwise shift in basic tax principles. 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. If such were the case, these amounts would already be subject to income tax under current law. Rather, section 226 of the Act would tax employees before they are actually paid on funds that are "at risk" and on amounts that might never be paid or that might end up being lower in value when they are ultimately paid.

Our members also question why the U. S. income tax system would favor current cash payments in lieu of deferred payments to employees. Employers may 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. 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. Section 226 of the Act would preclude such an arrangement.

There are also troubling technical aspects of section 226 of the Act that would make it difficult to administer and, therefore, easy to inadvertently violate when applied in the real world. As the attached examples illustrate, the "one times pay" prong of the dollar cap and the inclusion of "earnings" in the annual deferrals subject to the cap are both particularly pernicious. Section 223 of the Act would impose the Code section 409A tax penalty on earnings in excess of the applicable dollar 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.

Our members are also mindful that it was just a little over two years ago that Congress enacted the current-law section 409A provisions to regulate deferral elections and the timing of payouts for deferred compensation. 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 if a dollar cap is now imposed. Design decisions, administrative programs, and legal analyses for nonqualified plans all would have to be revisited in light of the dollar caps.

Finally, 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. Our members are concerned that 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.

Section 234—Expansion of Code section 162(m)

Section 234 of the Act would expand the definition of "covered employee" as defined under section 162(m) to include anyone who was ever a covered employee or anyone who served as CEO at any point during the year. The expansion of section 162(m) would expand further a provision that experts unequivocally agree is "broken." The staff of the Joint Committee on Taxation (JCT) recommended in 2003 that section 162(m) be repealed altogether. The recommendation was based on the JCT staff's conclusion that the provision is "ineffective at accomplishing its purpose [and] overrides normal tax principles." The JCT staff also noted that "[t]he concerns reflected in the limitation can better be addressed through laws other than the Federal tax laws." To that end, the Securities and Exchange Commission has promulgated expansive new proxy disclosure rules on executive compensation. Those provisions should be given time to work rather than embark on an attempt to once again use the tax laws to address perceived corporate governance problems.

Our members are also concerned that the section 162(m) proposal applies retroactively to amounts earned before 2007 and payments to which the employer is already contractually obligated. The lack of a binding contract exception is punitive. When Congress enacted the section 162(m) deduction limit in 1993, an exception was included for payments made under existing binding contracts that were not materially modified. We urge that Congress not retroactively change the tax laws with respect to binding compensation arrangements.

Examples

Restricted Stock Units. In recent years, many employers have redesigned their equity programs to increasingly rely on the use of restricted stock units (RSUs). Typically, employees 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. 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. Some RSU programs fit within the regulatory exception from 409A for compensation that is paid upon vesting (or within 2½ months after the year of vesting.) It is not uncommon, however, for employers to find that their RSU program does not meet the short-term deferral exception and that compensation paid under the program is subject to 409A. In some instances, an employee may vest in the RSUs in increments over the performance period but is not paid until full vesting is attained at the end of the performance period. In other instances, an employee may vest fully upon reaching a specified retirement age during the performance period. Under the legislation, such RSU grants would be subject to the "one times pay" limit and could cause employees to exceed the limit.

For example, a newly hired employee of a Fortune 500 company receives a grant of RSUs that is subject to 409A. The employee is granted 6,000 RSUs at a time when the value of the company's stock is $30 (i.e., value of the grant is $180,000). The employee is scheduled to vest in ⅕ of the RSUs each year over a 5-year performance period. The employee receives a base salary of $140,000, which under the Senate provision would be the employee's "one times pay" limit for the first year. Because the value of the RSU grant exceeds the "one times pay" limit, a 409A violation would occur and the employee would be subject to a 20% additional tax on the value of the RSUs as they vest (i.e., 20% of the RSUs per year) over the 5-year period.

Because "earnings" on the underlying shares of the company's stock also are subject to the limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the RSUs increased beyond the limit.

For example, an employee is granted 1,000 RSUs at the beginning of employment with technology company. The employee "vests" in these units after 5 years of service and the RSUs are designed to pay out after 10 years. The employer believes that this plan aligns the employee's interest with growing the company value rather than maximizing current salary. At the beginning of employment, the RSUs were valued at $15 per share. The employee earns approximately $100,000 per year and receives

modest increases (based on CPI of 3 percent). The employee's 5-year average taxable compensation from the company is $110,000 at the end of year 5. The company stock price stays relatively flat, but in year 6 the company becomes highly successful and the valuation of the stock takes off eventually to exceed 10 times the original price. The one-times-pay limit would be exceeded because the increase in the RSU value in year 6 will exceed $110,000.

Supplemental 401(k) Plans. 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 plan as additional deferrals that count against the "one times pay" limit and could cause the employee to exceed the limit.

For example, a Fortune 500 company offers a nonqualified supplemental plan to certain employees, including mid-level management employees receiving approximately $150,000 to $200,000 per year in total wages from the company. Many of these mid-level management employees are long-serving employees who typically defer 20 to 40 percent of their wages. Employees who participate in the plan receive a small matching contribution (typically between $3,000 and $6,000) from the company based on their deferrals. Investment earnings are credited to an employee's bookkeeping account in the plan based upon deemed investments chosen by the employee from among the same mutual funds as those offered in the company's 401(k) plan. Using 2006 data, the company has calculated that at least seven such employees would have exceeded their 5-year average taxable compensation. Below is a chart summarizing the relevant information.

Emp.	Years of Service	2006 Total Wages	5-year Average Taxable Wages	Account Balance As of 12/29/06	2006 Deferrals And Match	2006 Investment Earnings	Total Deferrals	Deferrals Above 5-year Avg Limit
1	27	$159,500	$ 90,180	$418,400	$ 66,700	$ 72,300	$139,000	$48,820
2	13	$175,400	$102,220	$508,300	$ 60,800	$ 52,500	$113,300	$11,080
3	28	$179,300	$ 62,380	$364,100	$116,400	$ 27,000	$143,400	$81,020
4	25	$178,300	$126,920	$614,700	$ 47,900	$109,100	$157,000	$30,080
5	30	$183,700	$126,040	$617,700	$ 38,000	$141,800	$179,800	$53,760
6	14	$194,400	$128,020	$486,500	$ 62,200	$ 73,200	$135,400	$ 7,380
7	6	$203,000	$ 92,020	$647,100	$ 76,300	$ 94,700	$171,000	$78,980

Two of these employees (5 and 7) would have exceeded their 5-year average taxable compensation based solely upon their 2006 earnings. Since earnings that are tied to a publicly-traded investment are often very unpredictable, any employee participating in a supplemental 401(k) plan would have to leave a large cushion below the "one times pay" limit to take into account potential earnings. Moreover, a long-serving employee could exceed the annual deferral limit based upon earnings even if the employee stopped making deferral elections.

For example, assume employee 5 in the above example stopped making deferral elections after 2006, and that the employee receives modest increases in wages each year (based on CPI of 3 percent). Also assume that the employee elected to have all of his account balance as of December 29, 2006 ($617,700) be deemed invested in the plan's S&P 500 index fund, and that for the 4-year period from 2007 to 2010 that fund's annual return was 20% per year (which would be consistent with the S&P 500's performance in the late 1990s). By 2010, there would be a 409A violation solely because the earnings credited to the employee's bookkeeping account ($213,477) exceeded the employee's 5-year average taxable compensation from the company ($189,376).

Non-elective, Supplemental Pension Plans. Some companies maintain non-elective, supplemental pension programs to serve as retention tools and assist management employees in saving for retirement. 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 re-

tirement (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 the "one times pay" limit 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 pension 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.

For example, one Fortune 500 company sponsors a non-elective, supplemental pension plan that is available to middle managers making a little over $100,000 per year, many of which work for the company's retail entity. The company noted the difficulty in calculating annual accruals for this type of plan and the fact that the value of annual accruals often varies significantly from year to year due to interest rate changes and eligibility for early retirement. To the extent an accrual under the supplemental pension plan exceeded the limit, it is not clear how the company could "fix" the pension plan formula to avoid an excess accrual. The company also noted that the impact of the "one times pay" limit would be even more severe because other forms of compensation provided to these managers, such as RSUs, performance units and severance pay, would also be aggregated with accruals under the supplemental pension plan in applying the limit. As a result, the company advised us that they may discontinue the supplemental pension plan if the annual limit is enacted.

Bonuses and Incentive Programs. Many employers structure their bonus programs to fit within the regulatory exception from 409A for compensation that is paid upon vesting (or 2½ months after the year of vesting.) It is not uncommon, however, for employers to find that they cannot meet this strict 2½ 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 payment being subject to 409A. Some employers may need to wait longer for performance criteria to be ascertained, financials certified, etc., resulting in the payment being subject to 409A and the "one times pay" limit. In other instances, an employee may vest in increments over the performance period or upon reaching retirement age but is not paid until the end of the period, which also would result in the payment being subject to 409A and the "one times pay" limit.

Private Equity. Many private companies (including start-ups) cannot readily conform to the specific administrative rules provided under the 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. Under the Senate bill, private companies could not provide this type of equity grant to employees unless the grant does not exceed the one times pay limit. Because "earnings" on the equity also are subject to the proposed limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the equity increased beyond the limit.

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 Senate bill limits the business from making any promise that exceeds "one times pay" for employees.

Statement of Association for Advanced Life Underwriting

I. *INTRODUCTION*

The Association for Advanced Life Underwriting ("AALU"), the National Association of Insurance and Financial Advisors ("NAIFA"), and the National Association of Independent Life Brokerage Agencies ("NAILBA") appreciate the opportunity to submit this statement to the Committee on Ways and Means in connection with its review of the revenue increasing measures approved by the Senate as part of the "Small Business and Work Opportunity Act of 2007." These comments focus on the Senate proposal to place an annual limit on the amount of compensation that may be deferred under a nonqualified deferred compensation plan.

AALU is a nationwide organization of life insurance agents, many of whom are engaged in complex areas of life insurance such as business continuation planning, estate planning, retirement planning, and deferred compensation and employee ben-

efit planning. AALU represents approximately 2,000 life and health insurance agents and financial advisors nationwide.

Founded in 1890 as the National Association of Life Underwriters, the National Association of Insurance and Financial Advisors comprised 800 state and local associations representing the business interests of 225,000 members and their employees nationwide. Members focus their practices on: life insurance and annuities, health insurance and employee benefits, multiline, and financial advising and investments. NAIFA's mission is to advocate for a positive legislative and regulatory environment, enhance business and professional skills, and promote the ethical conduct of its members.

The National Association of Independent Life Brokerage Agencies (NAILBA) is a nonprofit trade association with over 350 member agencies in the U.S., representing 100,000 producers who deliver more than one billion dollars in first year life insurance premiums annually.

AALU, NAIFA, and NAILBA strongly oppose the nonqualified deferred compensation proposal approved by the Senate. If enacted, the NQDC proposal would severely limit (if not eliminate) a vehicle many mid-level managers and employees now use to supplement their retirement savings. These mid-level managers are at times caught in a vise between limited social security benefits and a cap on 401(k) contributions that can be further reduced when overall employee participation in such a plan is lackluster. AALU, NAIFA, and NAILBA believe that concerns relating to nonqualified deferred compensation plans have been addressed by legislation enacted in 2004, which has been the subject of extensive (but as yet incomplete) guidance from the Treasury Department and the IRS.

Employers are struggling to implement the 2004 nonqualified deferred compensation rules and should not be subjected to additional burdens that may cause them to reconsider these important retirement savings vehicles.

II. *BACKGROUND ON NONQUALIFIED DEFERRED COMPENSATION*

Nonqualified deferred compensation is sometimes mistakenly confused with "executive compensation." It goes far beyond the ranks of top management and is integral to the ability of hundreds of thousands of mid-level managers and employees to save for retirement and for employers to recruit and retain high-quality employees.

A typical nonqualified deferred compensation plan is an arrangement under which a portion of an employee's salary is deferred until a future date. Generally, the employee is at risk for the deferred portion of their salary. Individuals typically enter into these arrangements as a means of saving for retirement, in many cases augmenting amounts saved through 401(k) and other qualified plans. Limits on such qualified plans—for example, a maximum annual contribution limit of $15,500 for 401 (k) plans—and a lengthening life expectancy make nonqualified deferred compensation plans particularly important savings tools for employees. Such plans are increasingly important in light of concerns regarding the future availability of social security benefits to retirees at middle to upper income levels. Both large and small employers view these plans as valuable tools for retaining and attracting talent.

In setting up a nonqualified deferred compensation agreement, the employer and employee typically will specify the percentage of current salary to be deferred and how earnings on the deferred amounts will be computed. In some cases, the agreement will specify a rate of return on the deferred amounts. In other cases, employees maintain an account in which they may make hypothetical investments that will govern the amount ultimately received by the employee. Some nonqualified deferred compensation arrangements—referred to as "non-elective" arrangements—do not involve voluntary deferrals by employees.

A nonqualified deferred compensation plan is not eligible for the tax benefits granted to qualified plans. Under a qualified plan, the employer may deduct the deferred compensation currently, as amounts are contributed to the plan, while the employee is able to defer paying taxes until receiving distributions from the plan. By contrast, in a nonqualified plan, the employer's deduction is postponed until the employee recognizes the compensation for income tax purposes. This matching of deductions and income inclusion effectively eliminates any revenue concerns on the part of the federal government and provides a cost-effective way for the government to encourage additional retirement savings beyond those for which qualified plan tax benefits are allowed.

Another key difference between nonqualified and qualified plans is that amounts deferred in a nonqualified plan are not protected in the event of the employer's bankruptcy. Assets intended to fund nonqualified deferred compensation must remain subject to the claims of the employer's general creditors. Thus, if the employer becomes insolvent, there are no assurances that the deferred amounts will ever be

paid to the employee. In this case, the employee simply becomes another unsecured creditor of a bankrupt company. Thus, employees with nonqualified deferred compensation balances have a greater interest in building a financially strong enterprise for the very reason that their retirement income is dependent on the long-term financial stability of the company.

EXHAUSTIVE RULES ALREADY ENSURE RESPONSIBLE USE

In 2004, Congress enacted sweeping additional requirements (Internal Revenue Code section 409A) on deferred compensation. The legislation imposed strict rules affecting deferral elections, funding, and distributions and imposed tax and penalties for violations of these rules. These rules were designed to ensure that employees do not have control over the receipt of income that is deferred. Regulations to implement the 2004 changes, which still have not been finalized, will run to hundreds of pages. Employers have already incurred, and will continue to incur significant legal and administrative expenses trying to navigate through the quagmire of these new rules. Code Section 409A and subsequent regulations surely address adequately any concerns about nonqualified deferred compensation.

BROAD BENEFITS OF DEFERRED COMPENSATION PLANS

With longer life expectancies, the need for substantial retirement savings, and restrictive limits on qualified retirement plans, deferred compensation plans have become important to a wide-range of employees and businesses. According to a recent survey by Clark Consulting, 91% of Fortune 1000 respondent companies have nonqualified deferred compensation plans.

Smaller businesses also commonly offer nonqualified deferred compensation programs. For large and small businesses alike, deferred compensation can be used as a tool to increase productivity and to retain employees who make important contributions to the businesses' bottom lines.

Of survey respondents with nonqualified deferred compensation plans, 28% allow employees with compensation below $100,000 to participate, and 63% allow employees with compensation below $150,000 to participate.

The following are some examples of plans now in operation:

1. A nationwide retailer based in the Midwest offers its nonqualified deferred compensation plan to 1,120 employees. Of the 962 participants, 68% have annual salaries between $66,000 and $120,000.

2. A nationwide specialty retailer based in the Southwest offers it nonqualified deferred compensation plan to 335 participants, 73% of whom have annual salaries below $120,000.

3. One of the nation's leading homebuilders offers its plan to almost 500 employees. 60% of those employees have annual salaries below $140,000, and 40% have annual salaries below $120,000.

These numbers counter any perception that individuals making less than $100,000 have little ability to save after they have "maxed out" contributions to 401(k) plans and IRAs. In reality, there are many reasons mid-level managers and employees need to utilize nonqualified plans. A common scenario is a "two-earner" couple whose combined income affords significant additional savings capacity. There also are situations where a worker making less than $100,000 is prevented—by operation of the tax law's nondiscrimination rules—from making his or her full contribution to a qualified plan. At the same time, particularly for small businesses, business leaders might see less merit instituting or maintaining a deferred compensation plan if they themselves were unable to benefit from a deferred compensation plan.

In summary, nonqualified deferred compensation represents a major source of personal savings for many employees. In light of the dramatically low rate of U.S. individual savings—the personal savings rate has dropped from 9% to a negative 1% since 1985—policymakers should consider ways to make it easier, not more difficult, for employees at all levels to save for retirement.

III. *SENATE PROPOSAL*

The nonqualified deferred compensation proposal approved by the Senate would limit an individual's annual deferral under a nonqualified deferred compensation plan to the *lesser of* (1) $1 million or (2) the individual's average taxable compensation from the employer during the preceding five years. The proposal would be effective for taxable years beginning after December 31, 2006. Earnings (whether actual or notional) attributable to post-December 31, 2006, nonqualified deferred compensation would be treated as additional deferred compensation subject to the proposal.

The Senate proposal applies to all amounts deferred under nonqualified deferred compensation plans (as defined under section 409A), including plans of both private

and publicly-held corporations. The proposal applies to non-elective deferrals as well as those that are elective.

Any deferrals in excess of those permitted by the Senate proposal would trigger severe tax sanctions. As a result of an excess deferral, all amounts deferred under the nonqualified deferred compensation plan for all taxable years (after 2006) would become immediately taxable (to the extent not subject to a substantial risk of forfeiture and not previously included in gross income).

In addition to current income inclusion, interest would be imposed as if the compensation had been taxable when first deferred (or, if later, when first vested). Finally, the amount required to be included in income would be subject to a 20-percent additional tax.

SENATE PROPOSAL DOES NOT MATCH STATED GOALS OF SPONSORS

Senator Charles Grassley has stated that the Senate's nonqualified deferred compensation proposal was intended to backstop the rules of Internal Revenue Code section 162(m),[1] which generally limits to $1 million a public company's deduction for compensation paid to the top five executives.

However, the Senate nonqualified deferred compensation proposal is not limited to public companies or to the top five employees of a company. It applies to all companies, public or private, and it applies to all employees participating in a nonqualified deferred compensation arrangement. Moreover, the Senate's nonqualified deferred compensation proposal is not limited to those deferring more than $1 million per year; the Senate's proposed annual deferral limit is the lesser of $1 million or the employee's average taxable compensation from the employer during the prior five years. As a result, the Senate proposal would limit deferred compensation for many mid-level managers and employees who would otherwise be making deferrals of far less than $1 million.

Senator Grassley has acknowledged problems with the proposal he and Senate Finance Committee Chairman Baucus placed before the Senate Finance Committee. During a January 31, 2007, interview with CNBC, Senator Grassley stated that the nonqualified deferred compensation proposal had "overreached."

COUNTING EARNINGS TOWARDS ANNUAL DEFERRAL LIMIT WILL CAUSE SIGNIFICANT PROBLEMS

The feature of the Senate proposal that would count earnings on previously deferred compensation towards the annual deferral limit is not administratively feasible and will cause significant problems. These include the possible triggering of tax, interest, and penalties on prior deferrals without any action on the part of the employee.

Because earnings on nonqualified deferred compensation are often variable, depending on the performance of underlying investment benchmarks (e.g., S&P 500), an employee cannot know with any certainty the amount of earnings that will be generated with respect to prior compensation deferrals. As a result, the employee cannot calculate with any certainty the maximum amount of salary that would be eligible to be deferred under the Senate proposal. For example, if an employee's average taxable compensation (after 401(k) contributions, health insurance withholdings, and dependent care withholdings) for the prior five is $50,000, the maximum amount the employee can defer, through a combination of salary reductions and earnings on prior deferrals, is $50,000. Because even inadvertent and de minimis deferrals exceeding the Senate limits would have significant adverse consequences, employees will be forced to seek only predictable, but relatively low earnings on their previously deferred compensation.

The longer the employee has participated in the nonqualified deferred compensation plan, the more significant the earnings component will be. At some point, just the earnings themselves on previously deferred compensation could cause an employee to exceed the permissible annual deferral. For example, if the employee above had previously deferred $550,000 and earned $55,000 on those prior deferrals during the current year, the earnings alone, without any additional salary deferrals, would cause the employee to violate the new deferral limit and trigger taxation of all prior deferrals plus a 20-percent penalty tax and retrospective interest.

For employees with nonqualified plan distributions occurring in years after the termination of employment, any earnings (even $1) on past deferrals could trigger the adverse tax consequences. For example, in the case of an employee who terminates employment in 2008, the average taxable compensation from the employer during a rolling five-year period will decline until it reaches zero after 2013. Thus,

[1] Section 162(m) is separately the subject of another one of the Senate's revenue increasing proposals.

any earnings in 2014 or later on undistributed prior deferrals will exceed the five-year average taxable compensation (i.e., zero) and trigger draconian tax results.

PROBLEMS WITH APPLICATION TO NON-ELECTIVE PLANS

Many employers provide deferred compensation to groups of employees on a non-elective basis; the employee groups covered by these arrangements can be quite broad. These arrangements (e.g. defined benefit arrangements), under which employers unilaterally defer the payment of a portion of current compensation, serve valuable employer goals such as employee retention. From a policy perspective, it makes no sense to limit an employee's deferred compensation under these non-elective deferred compensation plans where the employee has no choice as to whether the deferral is made.

In addition, the Senate proposal gives absolutely no guidance on how to apply the rules to such non-elective arrangements. The proposal does not provide any indication of how to compute the amount that is being deferred under a defined benefit arrangement and, instead, leaves this task to the Treasury Department and the IRS in regulations.

IV. *CONCLUSION*

AALU, NAIFA, and NAILBA believe that the Senate's proposed limitation on annual deferrals under nonqualified deferred compensation arrangements should not be adopted. Employers are still struggling to comply with restrictions on deferred compensation enacted in 2004, and guidance on many key issues involved in that earlier legislation has not even been proposed. The Senate's new proposed limits, with their operational complexity and potential for significant adverse tax consequences for even de minimis violations, may prompt employers to simply abandon nonqualified deferred compensation arrangements. Such a result would clearly run counter to the goal of encouraging Americans to save as much as possible towards retirement.

Statement of ERISA Industry Committee

Chairman Rangel, Ranking Member McCrery, and Members of the Committee, thank you for the opportunity to present the views of The ERISA Industry Committee ("ERIC") on the Senate revenue increasing provisions in H.R. 2 related to deferred and executive compensation.

ERIC is a nonprofit association committed to the advancement of America's major employer's retirement, health, incentive, and compensation plans. ERIC's members' plans are the benchmarks against which industry, third-party providers, consultants, and policy makers measure the design and effectiveness of other plans. These plans affect millions of Americans and the American economy. ERIC has a strong interest in protecting its members' ability to provide the best employee benefit, incentive, and compensation plans in the most cost effective manor.

PERCEPTION IS NOT REALITY

Recent media reports have highlighted the size of the compensation packages of some highly compensated senior corporate executives. These reports have created the erroneous perception that deferred compensation plans are abusive and available to only the most senior executives. They are not. Hundreds of thousands of dedicated, hardworking middle managers participate in deferred compensation programs. Far from being abusive, these programs serve legitimate purposes that benefit both employers and employees. They provide recruitment and retention tools for employers and needed retirement security for employees.

The ill-conceived deferred compensation provisions in the Senate-passed version of H.R. 2, the Fair Minimum Wage Act of 2007, are based on these erroneous perceptions. They represent bad employment policy and bad tax policy. In particular, the broad sweep of the provisions is unsuitable for legislation that purports to be aimed solely at the highest-paid executives. These provisions will cause many thousands of the nation's most talented and productive people—scientists, engineers, and researchers on whom the nation and its enterprises depend for economic vitality—to be blindsided by an egregious and retroactive tax increase.

ERIC strongly urges the House Ways and Means Committee to reject the Senate-passed deferred and executive compensation provisions and to exclude them from any legislation that the Committee approves.

THE CAP ON DEFERRED COMPENSATION EXCEEDS THE SCOPE OF ANY PERCEIVED PROBLEM

The limit on deferred compensation in the Senate bill goes far beyond its stated objective. The Senate Finance Committee's report indicates that the limit on deferred compensation is intended to target "the large amount of executive compensation" provided by arrangements that "allow executives to choose the amount of income . . . they wish to defer . . . in order to avoid the payment of income taxes." The limit imposed by the Senate bill, however, would curtail the compensation and benefits of many more employees than the executives referred to in the Senate Finance Committee report. Specifically, the deferred compensation limit would—

1) Apply to all employees, not just to executives;

2) Apply to nonelective plans—plans that provide deferred compensation automatically, without allowing the employees covered by the plan to elect how much they will defer—not just to elective plans;

3) Restrict the deferred compensation that an employee may earn in a year to an amount equal to *the lesser of* (a) $ 1 million or (b) the employee's average annual pay over a five-year base period—a limit that is much less than $ 1 million for the vast majority of employees;

4) Treat as *additional deferred compensation* any earnings that are credited in a given year on an employee's post-2006 deferred compensation, so that such earnings (a) are subject to the bill's limit on the amount of deferred compensation for that year and (b) reduce—possibly to zero—the limit on any other deferred compensation that the employee may earn in the same year;

5) Impose an annual limit on the *aggregate* of all of the benefits that an employee may earn under all of the employer's deferred compensation plans; and

6) Apply to every employee who participates in a plan that is treated as a deferred compensation plan by the Tax Code—regardless of whether the employee elected to participate in the plan, regardless of whether the employee had any influence over the amount of the deferred compensation that he or she is credited with under the plan, and regardless of the employee's motive or intent.

Contrary to the impression that the Senate Finance Committee report creates, many of the deferred compensation plans that would be affected by the deferred compensation limit, if it is enacted, do *not* give employees the option to defer part of their current pay. For example, a great many of the deferred compensation plans sponsored by employers are benefit restoration plans that are designed to provide pension benefits that the employer considers appropriate and would have provided through its tax-advantaged pension plan were it not for the limits that the Tax Code imposes on tax-advantaged plans. Benefit restoration plans are *not* optional plans that employees use for tax avoidance purposes. Eligible employees earn benefits under these plans automatically and pay income tax on the benefits they receive when they receive them.

Congress has limited the benefits that tax-advantaged plans may provide because of the tax benefits that those plans receive. In general, a tax-advantaged plan's investment income is exempt from income tax; the employees who participate in the plan are not taxed on their benefits until they actually receive them (and even then, participants can further defer the tax on some distributions by rolling them over into an IRA or into another tax-advantaged plan); and within limits, the employer can currently deduct its contributions to the plan—even though plan participants are not taxed on the employer's contributions to the plan, and are not taxed until the plan distributes benefits to them—often many years after the employer funded those benefits. Deferred compensation plans do *not* receive any of these benefits and, as a result, are not subject to the restrictions that apply to tax-advantaged plans.

The limits that the Tax Code imposes on tax-advantaged plans apply to such aspects of the plan as benefits, contributions, and the employee compensation on which plan benefits and plan contributions are based. These limits are designed to restrict the tax benefits that tax-advantaged plans receive and to assure that tax-advantaged plans provide benefits that do not favor highly compensated employees.

In many cases, however, the Tax Code limits have been imposed, or have been frozen or reduced, in order to achieve federal budgetary objectives, rather than retirement-income objectives. As a result, the Tax Code limits have not kept up with inflation and have prevented tax-advantaged plans from providing an increasing percentage of the benefits that they would otherwise provide to a growing number of mid-level employees. Employers have established benefit restoration plans and other nonelective deferred compensation plans to provide affected employees with the benefits that the Tax Code prevents a tax-advantaged plan from providing.

One example of the Senate's deferred compensation limit demonstrates the extreme penalty that an employee would be subjected to without any action on her

part. A Caucasian female manager, age 50, whose average five-year W–2 earnings is $144,000, would have been subjected to a $31,000 excise tax *plus* income tax on her deferred earnings if the provision had been in place for 2006. Her deferrals included irrevocable elections under a supplemental employee retirement plan, a bonus deferral plan, and earnings on previous deferrals. The egregious penalty on this hardworking middle manager's deferrals are the result of total deferral exceeding her five-year average W–2 earnings by a mere $11,000. As a result, the Senate's limit on deferred compensation triggers a 20 percent excise tax penalty plus income tax on the amount deferred even though the employee cannot receive any income from the deferrals until after retirement.

This example illustrates that the Senate bill's limit on deferred compensation will needlessly harm mid-level employees and raise a host of practical problems, including the following:

- If the value of an employee's deferred compensation benefit takes into account the value of an early retirement subsidy, the annual limit could harm many mid-level employees in the year when the value of their benefit restoration plan benefits "spike" as a result of the employee's entitlement to subsidized early retirement benefits. (The bill does not make clear whether the value of the subsidy can be ignored in a year if the employee does not actually retire in that year.)
- The annual limit would likely cause mid-level employees who participate in an early retirement window program to exceed the annual limit where a benefit restoration plan provides some or all of the window benefits.
- The annual limit also could cause mid-level employees to exceed the annual limit when they are laid off and become entitled to severance benefits that the Tax Code treats as deferred compensation.
- The compensation-based prong of the annual limit on deferred compensation would have a disproportionately severe effect on the benefits of mid-level employees whose annual compensation declines (and for whom the annual limit therefore declines) as a result of shifting to a part-time or seasonal position or participating in a phased retirement program.
- The annual limit would have a disproportionately severe effect on loyal, long-service employees who, by reason of their long service with their employer, have accumulated significant deferred compensation benefits that could be credited with substantial investment earnings in a single year.
- The treatment of investment earnings as additional deferred compensation could cause a mid-level employee to exhaust the annual limit on deferrals solely as a result of investment performance equaling or exceeding the annual limit for the year, and could thereby prevent the employee from accruing any other deferred compensation in that year.
- The treatment of investment earnings as additional deferred compensation also would make it impossible for an employee to engage in reliable advance planning designed to avoid exceeding the annual limit. For example, where the earnings that are credited on deferred compensation are tied to the performance of an equity security or an equity index, the earnings (and therefore the employee's deferrals) for the year could not be known until the last day of the year.
- The treatment of investment earnings as additional deferred compensation would perversely penalize employees for making successful investment decisions.
- Because the annual limit on deferrals appears to apply to foreign, as well to U.S., deferred compensation plans, a U.S. citizen who participates in both U.S. and foreign deferred compensation plans could be taxed on the deferred compensation under the U.S. plan as a result of being pushed over the limit on deferrals by the benefits that he or she accrues under the foreign plan.
- The compensation prong of the annual limit could stop outside directors from engaging in the benign practice of accepting deferred stock units instead of current directors' fees.
- Retirees who are credited with additional deferred compensation in years in which they receive no current pay would appear to exceed the annual limit for those years (zero).

EXPANDING THE 162(m) LIMIT WOULD PENALIZE COMPANIES FOR COMPLYING WITH CURRENT LAW

The Senate-passed version of H.R. 2 would also expand the limit that Section 162(m) of the Tax Code imposes on the deductibility of the compensation that a public company pays to certain current officers. The provision would make the Section 162(m) limit applicable to compensation that the company pays to individuals who

were covered by the deduction limit in any prior taxable year beginning after December 31, 2006.

Under current law, the Section 162(m) limit does not apply to compensation paid to former employees. If Section 162(m) is amended, in accordance with the Senate-passed bill, to apply to payments made after 2006 to former employees who were covered by Section 162(m) at any time after 2006, the limit would apply to payments that employers and employees deliberately deferred in the past in order to assure that, in accordance with the law then in effect, the deductibility of those payments would not be disallowed by Section 162(m).

It is bad tax policy to penalize employers for having done precisely what the tax law encouraged them to do. The Committee should reject the Senate provision.

EXORBITANT "TOLL CHARGE" FOR LEAVING THE U.S.

The Senate bill also contains a provision that would impose a "mark-to-market" regime on certain U.S. citizens who relinquish their U.S. citizenship and certain long-term U.S. residents who terminate their U.S. residency. In general terms, the bill would tax these individuals on the net unrealized gain in their property as if the property had been sold for its current fair market value. Subject to certain exceptions, the bill treats an interest in a Section 401(a) plan, a deferred compensation plan, or an IRA as property for purposes of this "deemed sale" rule.

The provision also includes a special rule for certain retirement plans, including Section 401(a) plans and certain foreign retirement plans. Under the special rule, instead of being subject to the "deemed sale" rule, the individual would be treated as having received an amount equal to the present value of the individual's vested accrued benefit on the day before he or she relinquishes U.S. citizenship or terminates residency in the U.S. If the plan later makes a distribution to the individual, the amount otherwise includible in the individual's gross income as a result of that distribution would be reduced to reflect the amount previously included in the individual's gross income.

A covered expatriate also would be allowed to make an irrevocable election to continue to be taxed as a U.S. citizen with respect to all property otherwise covered by the expatriation tax. If he or she makes this election, the individual would be required to continue to pay U.S. income tax on the income produced by the property, the individual would be required to post collateral to ensure payment of the tax, and the amount of the "mark-to-market" tax that otherwise would have been due (but for this election) would become a lien in favor the U.S. on all of the individual's U.S. property.

If enacted, these provisions would impose an exorbitant "toll charge" on individuals who leave the United States. Because the toll charge requires a departing long-term U.S. resident to pay tax on income that he has not received and may have no right to receive, this provision would, if enacted, discourage talented foreign employees from accepting assignments in the United States. It is bad policy to create such barriers to becoming a U.S. resident.

CONCLUSION

ERIC strongly urges the House Committee on Ways and Means to reject the Senate-passed deferred and executive compensation provisions and to exclude them from any legislation that the Committee approves. They are ill-conceived solutions to a problem that do not exist. If enacted, the provisions' principal effect will be to harm hundreds of thousands of mid-level employees who earn far less than the Senate Finance Committee's report and recent media coverage would suggest.

Financial Services Roundtable
March 13, 2007

The Honorable Charlie Rangel, Chairman
Committee on Ways and Means
United States House of Representatives
Washington, DC 20515

Dear Chairman Rangel,

The Financial Services Roundtable supports your efforts to examine the consequences of revenue raisers contained in the "Small Business and Work Opportunity Act of 2007" (the Act).

We oppose the revenue raisers in the Act which retroactively change the tax treatment of certain leasing transactions, which limit the opportunity and incentive for

employees to contribute to certain retirement plans, and which retroactively deny the deductibility of accrued compensation.

(1) Retroactive Tax Changes

The Roundtable opposes all retroactive tax changes because they undermine the entire foundation of the tax code. Retroactive changes create uncertainty and the inability to rely on the tax code. It makes it almost impossible for Americans businesses to price deals and to be competitive in a global economy.

The Roundtable opposes the Senate's retroactive revenue raiser on sale-in lease-out transactions. Removing the grandfather protection for these leasing transactions is simply wrong. It is particularly harmful to the companies which entered into these transactions legally and under the guidance of the federal government. For the government to now reach back and punitively tax these transactions is unfair and will have negative economic consequences. This change would adversely impact the stock market, the regulatory capital of the affected banks and further produce a weakening on investor confidence in corporate earnings.

During the 108th Congress, as part of the American Jobs Creation Act of 2004 (P.L. 108–357), a provision was included to make a prospective change to the tax treatment of certain leasing transactions, applying new rules to leases entered into after March 12, 2004. In the last Congress, a provision was proposed that would have changed the effective date for leases entered into on or before March 12, 2004. This provision was wisely rejected and should be rejected again.

(2) Limitations on Savings

The Roundtable is opposed to the provisions in the Act that would limit deferrals into nonqualified deferred compensation plans. These revenue raisers are overbroad and include many benefit programs outside of the intended scope.

The Act and would impose a dramatic shift in tax policy relating to the receipt of income. The proposals will force some employers to significantly reduce or abandon retirement and savings programs that benefit middle management employees in favor of current cash compensation. Further, the Act reduces the opportunity and incentive for employees and employers to plan for the retirement of their employees, and will make it harder to attract and retain employees. The flawed tax policy contained in the Act would result in a cash drain for many employers, resulting in less flexibility and needlessly add complexity in the administration of compensation arrangements.

Additionally, the Senate bill makes changes to Sec. 162(m) relating to the deductibility of executive compensation. These changes are intended to target large compensation payments to executives when they are no longer "covered" executives and thus no longer subject to the $1 million cap on the deduction for non-performance-based pay. Unfortunately, the Senate bill as currently drafted applies retroactively because a company would be denied a deduction for pre-2007 accrued compensation paid to an employee after 2006, if that employee is a CEO or one of the top four at any point in time after 2006. This section should be amended so it doesn't apply to any compensation to which an employee had a legally binding right, whether or not contingent, on January 17, 2007 or which relates to services performed before January 17, 2007.

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO

Roundtable member companies provide fuel for America's economic engine, accounting directly for $65 trillion in managed assets, $1 trillion in revenue, and 2.4 million jobs.

Best regards,

Steve Bartlett
President and CEO

Statement of Hogan & Hartson LLP

Transition Relief under Proposed Change to Section 162(m) Definition of Covered Employee—Necessary to Avoid Retroactively Denying the Employer's Deduction for Its Current Binding Obligation to Pay Compensation Already Earned for Services Already Performed

Background

Under current law, compensation in excess of $1 million paid by a public company to its "covered employees" is not deductible unless it is performance-based and has been approved by shareholders. (I.R.C. § 162(m)). "Covered employees" for this purpose are defined as the chief executive officer as of the close of the taxable year and the four other most highly compensated officers of the company whose compensation is required under the federal securities laws to be reported in the company's proxy statement for the year. The limitation applies in the year in which the compensation is paid out and the company takes the deduction.

It has been the longstanding rule since the enactment of section 162(m) in the Omnibus Reconciliation Act of 1993 that once an employee terminates employment with the company, he or she is no longer a "covered employee". As the House-Senate Conference Report adopting section 162(m) stated: "Of course, if the executive is no longer a covered employee at the time the options are exercised, then the deduction limitation would not apply." (House Rept. No. 103–213, at p. 585 n. 45 (Conference Report); House Rept. No. 103–111, at p. 647, n. 21 (Identical statement)). This rule has been repeatedly re-affirmed in longstanding IRS guidance. (*See, e.g.,* IRS Private Letter Rulings 200547006, 200042016, 200039028, 200019010, 199928014, and 199910011).

Proposed Change

Citing recent changes by the Securities and Exchange Commission to the group of company executives for whom compensation is required to be disclosed, the Senate's tax component of the minimum wage legislation proposes to adopt a new definition of "covered employee" and in so doing to reverse this longstanding current law rule under section 162(m) that once a person has terminated employment, he or she is no longer a "covered employee". (H.R. 2, sec. 234). Under the Senate provision, once having been a "covered employee", the person would remain so in perpetuity, even years after leaving the company. (Sen. Rept. No. 110–1). This proposed change would apply to taxable years beginning after December 31, 2006.

Transition Relief Is Necessary for Existing Binding Contracts

Entered into in Reliance on Longstanding Current Law Rules

The proposed change would have a retroactive effect of denying the company's deduction for its binding contractual obligation to pay compensation already earnedfor services already performed—all undertaken in reliance on the current law rules

Because the proposal would apply to taxable years beginning after December 31, 2006 and the section 162(m) limitation applies in the year in which the compensation is paid out, the proposed reversal of the longstanding definition of covered employee will apply retroactively to compensation that already has been earned for services that were rendered years ago. Since the section 162(m) limitation is a disallowance of the employer's deduction, the proposal has the effect of disallowing a deduction for compensation that an employer is contractually obligated to pay under binding contracts entered into years, even a decade or more ago, in reliance on the longstanding current law rule on covered employees as reflected in the legislative history of section 162(m) and repeatedly re-affirmed in IRS guidance.

Taxpayers enter into business agreements relying on the laws in effect at the time. Accordingly, Congressional tax-writers historically have been reluctant to adopt retroactive tax changes to avoid upsetting such reliance on the governing law at the time and imposing unexpected penalties or windfalls after-the fact

Congress has provided transition relief in similar situations for pre-Act deferrals and subsequent earnings

Original enactment of section 162(m)

In originally enacting section 162(m), Congress adopted broad transition relief for existing binding contracts, providing that the limitation did not apply to "any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such

remuneration is paid." (Section 162(m)(4)(D)). This broad transition relief extended to services to be performed in the future under the contract.

Section 409A rules for nonqualified deferred compensation arrangements

In enacting new section 409A which adopted broad changes to the rules governing nonqualified deferred compensation arrangements, Congress grandfathered not only pre-Act deferrals of compensation but also to post-Act earnings on such deferrals. Congress provided that "[t]he amendments made by this section apply to amounts deferred after December 31, 2004" and that such amendments "shall apply to earnings on deferred compensation only to the extent that such amendments apply to such compensation." (American Jobs Creation Act of 2004, P.L. 108–357, Sec. 885(d)).

Proposed cap on annual deferrals of nonqualified deferred compensation

Indeed, elsewhere in the same Senate minimum wage tax package, under the proposed new cap on annual deferrals of nonqualified deferred compensation, a grandfather is provided for both pre-Act deferrals of compensation and post-Act earnings on such deferrals. Under the Senate bill, the new cap applies "only to amounts deferred after December 31, 2006 (and to earnings on such amounts)." (Sec. 226(b) of H.R. 2).

Proposed Transition Rule

Consistent with the approach taken by Congress in these similar contexts, the proposed transition rule would provide a binding contract exception. Indeed, the transition rule would be even tighter, being limited to compensation that has been earned for services that already have been performed. More specifically, the proposed change to the section 162(m) definition of covered employee would not apply to remuneration (as defined under section 162(m)(4)(E), including amounts deferred and earnings on such deferrals) for services that were rendered in a taxable year beginning before January 1, 2007 and payable under a written binding agreement which was in effect on December 31, 2006 and which was not modified thereafter in any material respect before such remuneration is paid.

Possible Amendment to Section 162(m) Proposal to Provide Transition Relief to Protect

Existing Binding Contracts Entered Into in Reliance on Longstanding Current Law Rules

Section 234 (regarding modifications of definition of employee covered by denial of deduction for excessive employee remuneration) of Title II (the "Small Business and Work Opportunity Act of 2007") of H.R. 2 is amended to read as follows:

SEC. 234. MODIFICATIONS OF DEFINITION OF EMPLOYEE COVERED BY DENIAL OF DEDUCTION FOR EXCESSIVE EMPLOYEE REMUNERATION

"(a) IN GENERAL.—Paragraph (3) of section 162(m) is amended to read as follows:

"(3) COVERED EMPLOYEE.—For purposes of this subsection, the term 'covered employee' means, with respect to any taxpayer for any taxable year, an individual who—

"(A) was the chief executive officer of the taxpayer, or an individual acting in such a capacity, at any time during the taxable year,

"(B) is 1 of the 4 highest compensated officers of the taxpayer for the taxable year (other than the individual described in subparagraph (A)), or

"(C) was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2006.

In the case of an individual who was a covered employee for any taxable year beginning after December 31, 2006, the term ?covered employee' shall include a beneficiary of such employee with respect to any remuneration for services performed by such employee as a covered employee (whether or not such services are performed during the taxable year in which the remuneration is paid).'.

"(b) EFFECTIVE DATE.—

"(1) IN GENERAL.—The amendment made by this section shall apply to taxable years beginning after December 31, 2006.

"(2) EXCEPTION FOR EXISTING BINDING CONTRACTS.—The amendment made by this section shall not apply to remuneration (within the meaning of section 162(m)(4)(E) of the Internal Revenue Code of 1986, as amended, including amounts deferred and earnings thereon) for services that were rendered in a taxable year beginning before January 1, 2007 and payable under a written binding agreement

which was in effect on December 31, 2006 and which was not modified thereafter in any material respect before such remuneration is paid."

Statement of HR Policy Association

Thank you for holding this hearing and for this opportunity to present the views of the HR Policy Association regarding the impact of Sections 206 and 214 of H.R. 2, the Small Business Work and Opportunity Act. We believe that these sections, which would impose substantial limits on annual deferrals of nonqualified deferred compensation and significantly change the treatment of nonqualified deferred compensation for former "top five" executive officers, would create significant unintended consequences and should be eliminated from any final bill that is sent to the President.

HR Policy Association is a public policy advocacy organization representing the chief human resource officers of over 250 leading employers doing business in the United States. Representing nearly every major industry sector, HR Policy members have a combined U.S. market capitalization of more than $7.5 trillion and employ more than 18 million employees world wide. Our members are particularly interested in sound executive compensation practices because they are responsible for assisting boards of directors and board compensation committees in developing compensation programs for executives. Our members are very concerned that Congress consider the full effects of tax law changes intended to limit executive compensation. In the past, such changes have had the opposite effect from that intended, and may have accelerated increases in executive compensation.

Section 206 of the Small Business Work and Opportunity Act would amend section 409A of the tax code to cap the amount an individual could defer into a nonqualified deferred compensation arrangement annually. The cap would be the lesser of (a) $1 million or (b) the average of the individual's gross income over the five years preceding the year in which the deferral election is made. As described below, the cap would have a significant impact on middle managers and would make even more complex an extremely arcane tax law provision.

Nonqualified Deferred Compensation Plans Used to Provide Benefits Restoration to Managers and Executives

Nonqualified deferred compensation plans generally are used as retirement savings vehicles. Their underlying purpose is to permit managers, sales employees, and executives to defer until retirement a percentage of their regular pay that is more comparable to the percentage of regular pay deferred in qualified retirement plans by lower-level employees. Like qualified retirement plans, nonqualified plans permit the deferral of compensation, which in this case means that compensation is credited to the plan for later withdrawal, usually at retirement. The plans are nonqualified, meaning that they do not receive the special tax advantages of "qualified" retirement plans, including that employers are not allowed to deduct plan contributions in the year they are made. Instead, the company must wait to deduct the compensation as an expense until the year the employee receives the income. The mechanics of this are strictly regulated by tax code section 409A, which Congress passed in 2004 and for which the IRS and Treasury Department have not yet finalized regulations.

The deferral of compensation in nonqualified arrangements comes with a risk that the individual will never receive the money, because the arrangements generally are unsecured. Unlike qualified plans, no money is set aside for participating employees, and there is no guaranty that the funds will be paid. The arrangements normally do not provide participating employees protection from creditors in bankruptcy or insolvency. This lack of security acts as an incentive to all employees, and particularly senior executives, to manage the company prudently. It also enables companies to preserve resources for operating the company, rather than paying it directly to the employees.

Restrictions on Deferred Compensation Will Affect Many More Employees Than Senior Executives

The expansion of section 409A in Section 206 will affect far more employees than just senior executives, because a broad array of employees—from middle managers, to junior executives, to CEOs—often participate in their employer's nonqualified deferred compensation programs. There is no one-size-fits-all program. In fact, among HR Policy member companies, the type of arrangements and number of participants varies with the size of the company and their overall compensation structure. Most

large companies have several hundred employees participating, and in some companies, several thousand participate. Especially at the lower levels, those who participate most often do so because of the opportunity for benefits restoration.

Cap on Nonqualified Deferred Compensation Would Have Unintended Effects, Limit Severance Programs

The cap on nonqualified deferred compensation would limit the opportunity for benefits restoration, especially for the lower tier of employees who participate in these arrangements. The proposal's deferral limitation, which is an average of the five years of gross income before the year in which a deferral election is made, will significantly limit the percentage of compensation middle and senior managers can defer. This would be an issue for those employees who have risen rapidly into or beyond the middle management ranks and whose income has increased proportionately during that time.

In addition, the proposal will affect arrangements that fall within the scope of 409A, but that have traditionally not been considered deferred compensation. For example, the limit on deferred compensation would impose a 20 percent excise tax penalty on individuals who may automatically be eligible for broad-based severance programs that provide more than one year's salary. Severance benefits often include two years' salary for senior managers, for example, to protect trade secrets or to provide a transition in the event of a merger or acquisition.

Proposal Would Limit Further Complicate Arcane Deferral Rules Under Section 409A

The $1 million cap on nonqualified deferred compensation also will further complicate the extremely complex area of tax law under section 409A of the tax code. Congress passed 409A in 2004, and because of the complexities involved in applying the law to uniquely tailored programs, the Treasury Department has not yet finalized implementing regulations. Thus, it is difficult to determine the effects this change will have on nonqualified deferred compensation programs, especially those that are already in effect or that may be arranged through employment contracts.

Retroactive Changes to Section 162(m) Would Perpetuate Unintended Consequences

Section 214 of the proposal also would extend the application of 162(m) by expanding the definition of "covered employee" to include any individual who had previously served as CEO or one of the other four most highly compensated executive officers. The change would apply retroactively to amounts employers are already contractually obligated to pay and would provide for no transition to enable employers to alter their compensation strategy prospectively.

More importantly, this change expands a tax code section that, as Securities and Exchange Commission Chairman Christopher Cox recently described, was intended "to control the rate of growth in CEO pay." He added: "With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the Museum of Unintended Consequences." This lack of effectiveness led the Joint Committee on Taxation staff to recommend repealing Section 162(m) altogether in its 2003 report on Enron. HR Policy opposes this provision because rather than heed the lessons of history, the bill expands and complicates section 162(m) further.

In sum, we oppose the restriction on nonqualified deferred compensation imposed by Sections 206 and 214 of the tax code. We believe the restrictions in Section 206 would encourage companies to eliminate the benefit for lower-level executives while keeping senior executives whole in other ways. Moreover, the change would remove an important incentive for many senior executives to manage the company prudently. Likewise, the restrictions in Section 214 would undermine assumptions companies had made when originally entering into compensation arrangements with senior executives and would further complicate a section of the Code that has failed to accomplish its intended purposes.

Thank you for the opportunity to express our views on this important legislation. Please do not hesitate to contact us if you have any questions.

Statement of Richard D. Ehrhart

My Background. I am a deferred compensation expert with a unique combination of perspectives developed over 26 years of work in the deferred compensation industry. For 18 years I was a tax and benefits attorney specializing in deferred

compensation. For the past 8 years, I have been a small business owner and executive running Optcapital. Optcapital helps employers design and administer deferred compensation plans. We work with public and private companies from large Fortune 1000 firms to small businesses. I have written extensively about deferred compensation. Most recently, I published "Section 409A: Treasury Newspeak Lost in the Briar Patch," 38 The John Marshall Law Review 743 (Spring 2005). For more than 20 years, I have been a member of the Employee Benefits Committee of the Tax Section of the American Bar Association.

The Bill's Background. On January 10, 2007, the House of Representatives passed H.R. 2, the "Fair Minimum Wage Act of 2007," which would increase the Federal minimum wage for the first time in ten years. On February 1, 2007, the Senate passed its own version of H.R. 2. The Senate-passed version coupled an increase in the Federal minimum wage with a package of tax benefits costing $8.3 billion over ten years. In order to offset the cost of these tax benefits, the Senate bill includes over a dozen separate provisions that, in the aggregate, would raise $8.3 billion over ten years. These offsetting revenue increases would, among other things, change the tax treatment of certain leases entered into before March 12, 2004, deny deductions for certain government-required payments and punitive damages in civil actions, enact new limitations on nonqualified deferred compensation ("NQDC") plans, and change the tax treatment of certain financial instruments.

The bill includes two separate NQDC limitations. The first would limit annual deferrals under NQDC plans to an employee's average taxable compensation from the employer during the preceding five years or, if less, $1 million (the "409A CAP"). Additionally, the proposal contains an expansion of the class of individuals who are subject to the $1 million cap on deductible compensation under Code Section 162(m) to include all individuals who qualify as "covered employees" at any time on or after January 1, 2007 (the "162(m) EXPANSION").

The Joint Committee on Taxation ("JCT") has projected the 409A CAP to generate $800 million of tax revenues over 10 years. It has projected the 162(m) EXPANSION to raise $100 million over 10 years.

My Recommendation. As explained below, the 409A CAP is ill conceived and would damage the economy, the competitiveness of American businesses and U.S. financial markets. It would not raise tax revenues, but reduce them. It would not reduce executive pay, but greatly expand the use of stock options. It would also expand the use capital gains for services.

The 409A CAP is a "mega-ton nuclear bomb" sort of legislation that would kill all NQDC for all companies, public and private, large and small. Private companies (which can't use stock options) would be disadvantaged versus public companies. More important, U.S. companies would be handicapped in competing with foreign companies, inasmuch as no other industrialized nation limits NQDC.

The 162(m) EXPANSION, by contrast, is a "smart missile" approach that can be effective in reducing executive pay, without hurting the competitiveness of U.S. companies in global markets for talent. Instead of killing NQDC, and the long-term wealth that NQDC helps to generate, it simply raises the cost of "excessive" pay for the top 5 executives of public companies.

In its September 5, 2006 Report entitled "Present Law and Background Relating to Executive Compensation, the JCT identified two major loopholes in Section 162(m) and recommended that they be closed. The Senate Finance Committee's proposal would only partially close just one of the two loopholes. By closing all the loopholes in Section 162(m), the revenue tag of the 162(m) EXPANSION would probably be in the billions.

In sum, if NQDC must be restricted, then we strongly urge Ways and Means to abandon the 409A CAP and fashion a 162(m) EXPANSION amendment that plugs the loopholes the JCT has identified.

NQDC Is Essential to the Competitiveness of U.S. Business. Most employers use NQDC. They use NQDC to reward key employees. NQDC consists of promises to pay specified benefits in the future. For many businesses, NQDC is essential for sustainable growth. The market for top talent is highly competitive. U.S. companies compete globally for management, sales and marketing labor. The ability to provide long-term incentives is vital to attracting and retaining key employees. It is also absolutely critical to ensure that motivations and contributions of key employees are aligned with shareholders' interests.

For example, we started Optcapital in 1998. NQDC enabled us to attract some of the best minds available. Most of them came from the big companies like Wachovia, Bank of America, U.S. Trust and Deutsche Bank. We could not compete with these firms on the basis of current compensation. Without the ability to promise substantial NQDC, we could not have acquired the talent we needed.

NQDC Is Tax Revenue Neutral. NQDC is "nonqualified" because it is for a select group of higher-paid employees over and above the limits of qualified retirement plans. Because it is nonqualified, the employer does not receive a tax deduction for NQDC until the employee realizes the NQDC as gross income. See Section 404 of the Internal Revenue Code (the so-called "matching rule").

When a U.S. business provides NQDC to a U.S. service provider, the U.S. business does not receive a federal income tax deduction until the NQDC is includible in the service provider's gross income. Because federal tax rates on ordinary income are about the same for corporations and individuals, NQDC should be tax revenue neutral. For example, if an employee defers a $10,000 bonus, the employee would avoid $3,500 of income taxes currently. The corporation's taxable income would increase by $10,000, causing a $3,500 increase in its federal income taxes.

The JCT estimates that the 409A CAP would generate $800 million over 10 years. The projection is badly flawed. It attempts to take into account tax effects from activities that are related to NQDC, but are not NQDC. Many taxable corporations informally fund their NQDC using corporate-owned life insurance ("COLI"). If a bank uses it, it is commonly called "BOLI." COLI and BOLI are *tax-exempt* investments. The JCT assumes that if NQDC is capped or killed, then the use of COLI or BOLI will decrease, and tax revenues will increase.

Keep in mind that NQDC is nothing more than the employer's unfunded, unsecured promise to pay a specified benefit in the future. An employer may or may not choose to informally fund its NQDC obligations. Informal funding is not a necessary consequence of NQDC. Many employers do not informally fund their NQDC. And many that do choose to informally fund use taxable investments rather than COLI or BOLI.

It should also be noted that the use of COLI and BOLI as informal funding has expanded far beyond NQDC. Banks are probably the biggest user, and they use it to informally fund post-retirement medical and other employee and executive benefits.

Each year, COLI and BOLI cause billions of direct tax revenue losses.

The JCT's tax revenue analysis is incomplete because it fails to take into account all the effects the 409A CAP would have on tax revenues. It does not account for the damage to competitiveness, nor how the 409A CAP would drive public companies to a much heavier use of stock options, and private companies to a much heavier use of capital gains-type income.

The estimate of the amount of tax revenue that the 162(m) EXPANSION would raise is far more defensible. The effects of limiting NQDC deductibility are directly measurable. Although the 162(m) EXPANSION that closed all the loopholes could be expected to have a moderating effect on executive pay, its potential negative effects to tax revenues would be minimal. Moreover, if all the 162(m) loopholes were closed, the 162(m) EXPANSION would raise billions over 10 years.

The Problems with the 409A CAP. The proponents of the 409A CAP contend that it merely limits an employee's deferred comp to $1 million each year. Do not be fooled. Its practical effect would be to kill the use of deferred comp. First, the 409A CAP is virtually impossible to administer. It applies across all plans, including account balance plans (defined contribution plans), nonaccount balance plans (e.g., defined benefit plans), severance plans and stock plans. It ostensibly includes earnings on principal credits. The limit is not $1 million, but the lesser of (A) $1 million or (B) the employee's 5-year average pay.

Bear in mind that the 409A CAP would be an added requirement of Section 409A. The existing 409A rules, now in proposed regulation form, run 240 pages. They are highly technical and complex. Most important, however, is that a failure to comply with all the 409A requirements subjects all plan participants to immediate taxes, interest and a 20% penalty. Thus, the 409A CAP is not simply a ceiling on the amount that can be tax-deferred. The consequence of providing more than the limit is not simply current taxation on the excess, but taxes, interest and penalties on all the deferred compensation of all participants.

The proposed CAP is like a speed limit that is based on your weekly average speed where the penalty for speeding is loss of your car. The CAP carries such drastic consequences, our prediction is that employers would decide that the "game is not worth the candle."

The 162(m) EXPANSION. The 162(m) EXPANSION is an amendment to Code Section 162(m). Congress enacted 162(m) in 1993. It provides that a public corporation may not deduct amounts paid to a "covered employee" during a taxable year to the extent such amounts exceed $1 million. A "covered employee" includes the CEO as of the close of the taxable year and the four highest compensated officers as of the close of the taxable year (other than the CEO) whose compensation is required by the SEC to be reported under the Securities Exchange Act of 1934.

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration paid in a medium other than cash. The following types of compensation are specifically excluded:

(1) commissions;

(2) performance-based compensation;

(3) contributions to tax-qualified retirement plans;

(4) amounts excluded from gross income such as health benefits and Section 132 fringe benefits; and

(5) remuneration payable under a binding contract that was in effect on February 17, 1993.

In its September 5, 2006 Report entitled "Present Law and Background Relating to Executive Compensation, the JCT notes as follows:

The legislative history states that section 162(m) was motivated by then-current concerns regarding the amount of executive compensation in public companies, and that the purpose of the provision was to reduce "excessive" compensation. While not specifically mentioned in the legislative history, the exception to the limitation for performance-based compensation reflects the view that such compensation, by its nature, is not "excessive". A provision similar to section 162(m) was also proposed by the Clinton Administration. The rationale behind this provision was stated a bit differently, and focused on the "unlimited tax benefit" provided to executive compensation. This tax benefit was described as particularly inappropriate in cases in which executive compensation increased while company performance suffered. The Administration proposal also had as a stated objective the intent to provide an incentive to link compensation to business performance. Since the enactment of section 162(m) the appropriateness of executive compensation has remained a topic in the public eye.

The Report also notes that "According to a number of studies, Section 162(m) has not reduced the growth in executive compensation." The Report cites studies that conclude that 162(m) contains various "loopholes" that should be closed to effect the desired reduction of executive compensation. First, the performance-based compensation exception is overly broad. Second, the limitation does not apply once a covered employee terminates employment. Thus, it has been easy for employers to evade the limit simply by shifting pay to performance-based compensation and by deferring pay to after termination of employment. The Report suggests the following ways of plugging the gaps in 162(m):

(1) eliminate the performance-based compensation exemption and apply a limit to all remuneration;

(2) instead of exempting all performance-based compensation, exempt only a specified dollar amount;

(3) restrict the performance-based compensation exemption to compensation that is truly performance-based (such as indexed options or options that are granted at a specified premium strike price above the current market price); and

(4) expand the definition of covered employee to include any employee or former employee who was a covered employee at any time in the past.

The proposed 162(m) EXPANSION takes approach No. 4. It contains an expansion of the class of individuals who are subject to the $1 million cap on deductible compensation under Code Section 162(m) to include all individuals who qualify as "covered employees" at any time on or after January 1, 2007.

162(m) is a Better Mousetrap. The 162(m) EXPANSION approach—disallowing the deductibility of compensation deemed excessive—is far superior to the 409A CAP as a means of curbing executive compensation. It makes deferred comp for the top 5 executives of public companies substantially more expensive. If a compensation committee were to provide compensation in excess of the 162(m) limits, it would have to answer to shareholders. Such nondeductible compensation would come under intense scrutiny and would need to be justified. Moreover, the 162(m) approach would not kill deferred comp, but merely ration it by increasing its cost at the upper levels.

A simple way to change would be to delete the phrase "at any time on or after January 1, 2007." This would pick up all former "covered employees." We suspect this change alone would produce close to $1 billion of revenue.

Any of approaches Nos. 1 through 3 would also generate many billions of revenues. My personal preference would be to eliminate the performance-based compensation exemption altogether, and simply apply a higher limit to all compensation. For example, why not simply apply a $5 million deductibility limit to *all compensation*. Such a law would be relatively easy to administer, and avoid the definitional and interpretation problems that comes with carving out exceptions.

Statement of Air Products and Chemicals, Inc., Allentown, PA

I am pleased to have the opportunity to testify this morning on behalf of the National Association of Manufacturers (NAM) on several revenue raising provisions included in legislation currently pending in Congress. We applaud the committee's initiative in holding the hearing.

My name is Ken Petrini and I am Vice President, Taxes at Air Products and Chemicals, Inc., in Allentown, Pennsylvania. I also serve as the Chairman of the NAM's Tax and Budget Policy Committee. The NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. NAM members believe strongly that tax relief is critical to durable economic growth and job creation. In contrast, revenue raisers—like those I will describe in my testimony—would impose new taxes on many businesses, making it more difficult for them to compete in the global marketplace.

In particular, the Small Business and Work Opportunity Act of 2007 (H.R. 2) as amended by the Senate on February 1, 2007,[1] includes several tax increases that are of particular concern to American manufacturers. These include proposals to:

- **Deny Deductions for Punitive Damage Payments;**[2]
- **Deny Deductions for Settlement Payments;**[3]
- **Limit Deferrals Under Nonqualified Deferred Compensation Plans;**[4]
- **Expand the Definition of Employees Subject to Rules Limiting the Deduction for Salary Payments, and**[5]
- **Impose New Taxes on Expatriates.**[6]

A common theme with these changes is that, while they may be rooted in some valid policy concerns, they are drafted in such a way to be overly broad and threaten to ensnare transactions and expenses well beyond their intended scope.

Increasing Legal Costs for American Manufacturers

Manufacturers currently face some of the highest legal costs in the world. Based on a recent study by NAM's research and education arm, the Manufacturing Institute, tort costs for U.S. businesses are at historical highs and are higher than similar legal costs in other countries.[7] Moreover, the tort burden on manufacturers (as a percentage of manufacturing output) is roughly 2.2 times larger than the burden of these costs on other sectors of the economy.[8]

Two provisions in the Senate-passed version of H.R. 2, if enacted, would add to the current, anti-competitive legal cost burden facing U.S. manufacturers. Specifically, the proposals to eliminate tax deductions for punitive damages and settlements of potential violations of law represent significant changes to, and unnecessary expansion of, current law that will increase the cost of doing business in the United States for manufacturers.

Punitive Damages

Under current law, taxpayers generally can deduct damages paid or incurred as a result of carrying on a trade or business, regardless of whether the damages are compensatory or punitive. The proposed change to make punitive damage payments in civil suits non-deductible, whether made in satisfaction of a judgment or in settlement of a claim, runs counter to fundamental and well-established tax principles, and represents unsound public policy.

From a tax policy perspective, the proposal represents a sharp departure from the income tax principle that taxpayers should be taxed on net income. To measure net income accurately, all expenses associated with the production of income are properly deductible.

Similarly, the proposal violates the principle that income should be taxed only once. Since punitive damage awards would not be excluded from income, both the payor *and* the recipient would be subject to tax on the punitive damages, thus imposing a "double tax" on the same income. The United States Treasury would get a windfall, but businesses would receive a "tax penalty."

The proposal also represents a departure from another objective of federal tax policy—to provide similar tax treatment for similar behavior. Because of different

[1] Fair Minimum Wage Act of 2007 [H.R. 2 EAS], as passed by the Senate, 2/1/07
[2] Ibid, Section 223
[3] Ibid, Section 224
[4] Ibid, Section 226
[5] Ibid, Section 234
[6] Ibid, Section 225
[7] "The Escalating Cost Crisis," p. 11 The Manufacturing Institute, 2006.
[8] Ibid

standards and guidelines in the current civil justice system, conduct that results in punitive damages in one state may not result in punitive damages in another. For example, standards for awarding punitive damages vary widely among states—a number of states have "caps" on punitive damages and some states do not allow punitive damage awards at all.

NAM also is concerned about significant tax administration issues under the proposal. Under current law, it is often difficult to determine the character of awards (i.e., compensatory vs. punitive), particularly in cases that are settled in a lump sum while on appeal. The term "punitive" is not defined in the tax code or regulations nor is the term defined in the proposal. The Tax Court has held that state law determines whether awards are punitive or compensatory in nature, which suggests that the proposal could result in dramatically different treatment of otherwise similarly situated taxpayers in different locales.

Moreover, one jury may award damages while another may decide there is no liability even where the facts are very similar. A prime example is *BMW of North America v. Gore.*[9] In this case, a jury awarded the plaintiff $4 million in punitive damages because BMW had sold as new a car that had received touch up paint treatment. In contrast, a few months earlier, another jury in the same county in a case with the same defendant and nearly identical facts found no liability.

Another area of concern for NAM members is the effective date of the proposal. Disallowing deductions for amounts paid or incurred on or after the date of enactment would *interfere with a taxpayer's decision today whether to appeal an initial award of punitive damages. Because the deduction would continue to be available only for amounts paid before the enactment date, taxpayers recently hit with initial damages awards would be discouraged from exercising their right to appeal. Moreover, existing damage award amounts have been based on the assumption that such amounts would be deductible. Disallowing deductions for these existing awards would impose a far greater penalty on taxpayers than was intended by judges and juries.*

From a broader public policy perspective, the proposal is based on the false premise that punitive damages are the same as non-deductible criminal or civil fines. Criminal or civil fines are fixed in amount and are imposed for specific activities that are defined in advance. In addition, criminal liability must be proven "beyond a reasonable doubt," i.e., the jury must be virtually certain of its decision. In contrast, punitive damages are awarded after the fact under vague and unpredictable standards such as "reckless" or "wanton" or "gross negligence" or all three.

Settlement Payments

NAM members also have significant concerns about the impact of the proposal that would prevent companies from deducting the cost of settlement agreements with the government. Like the proposal discussed earlier, this provision runs counter to fundamental and well-established tax principles, and represents unsound public policy.

Under current law, a business cannot deduct from income "any fine or similar penalty paid to a government for the violation of any law." The proposal would significantly extend this provision to the non-penalty portion of settlement payments, thus eliminating deductions for most, if not all, settlement agreements with the government on a wide range of issues, regardless of whether there was any wrongdoing.

NAM members believe that the language as drafted would sweep in a large number of unintended and legitimate expenses. In particular, the "inquiry into the potential violation of any law" clause included in the proposal could be read to include almost all payments made by a business in connection with daily, routine interaction with government agencies. By eliminating a deduction for an ordinary and necessary business expense, the proposal represents a dramatic change in longstanding tax policy that would act as a disincentive for companies to enter into these agreements.

Manufacturers operating today in the United States face a significant regulatory burden. In many cases, these regulations are ambiguous and subject to interpretation making it difficult, if not impossible, to ensure 100 percent compliance at all times. Consequently, there is a strong public policy reason to have a system that allows businesses to voluntarily settle and pay government claims.

Moreover, current law establishes a distinction between punitive and nonpunitive payments that has a long history in the courts and with the Internal Revenue Serv-

[9] 517 U.S. 559

ice.[10] According to IRS officials, the IRS is committing "significant resources" to ensure the proper treatment of settlement payments.[11] In contrast, the proposed change would replace this well-established and workable precedent with a new, all-encompassing standard with which the courts and the IRS would have to struggle. The approach taken by the proposal is to disallow a broad category of deductions (legitimate and otherwise), and require taxpayers to rely on limited exception language to claim clearly proper deductions. Ironically, the need to fit oneself into the narrow scope of the exception would limit some of the flexibility that exists today in responding to real or perceived violations of laws and regulations and would limit the ability of business and government to agree on certain remedies that benefit society.

Clearly, American consumers and businesses would lose if the proposals on punitive damages and settlements were adopted. U.S. manufacturers face significant government regulation and operate in a world where no product is or can be absolutely perfect. These proposals would hamper entrepreneurship, innovation, and product development by further adding to the cost of doing business. This, in turn, would increase the price of goods and services for consumers, chill innovation, put jobs at risk and undermine U.S. competitiveness.

Unwarranted Attacks on Benefits and Compensation

Nonqualified Deferred Compensation

NAM member s strongly oppose a provision in the Senate-passed version of H.R. 2 that would impose significant limitations on nonqualified deferred compensation plans. The proposal, which is not targeted at any abuse of deferred compensation rules, is a solution in search of a problem that would effectively eliminate the ability of employers to use deferred compensation as a retention tool for valued employees.

In 2004, Congress adopted significant changes to nonqualified deferred compensation laws that were designed to address perceived abuses. The legislation—the American Jobs Creation Act of 2004[12]—created a new tax code section (Section 409A) that significantly reformed existing rules for the establishment and operation of nonqualified deferral arrangements.

In particular, Section 409A was designed to address perceived abuses of nonqualified deferred compensation plans, principally whether the individual making the deferral had control of the deferred assets. Under 409A, amounts deferred under nonqualified arrangements must remain at a substantial risk of forfeiture to the employee. Final regulations to implement Section 409A (which are expected to run to hundreds of pages) have yet to be finalized by the Treasury Department. NAM members believe that Congress should allow the new law to work before considering additional changes.

In contrast, the proposal included in the Senate bill would further restrict the rules on nonqualified plans by limiting annual deferrals to the lesser of the five-year average of an individual's taxable compensation or $1 million. The legislative history of the provision[13] makes clear that earnings inside a deferred compensation plan should be counted towards the annual cap on deferrals. As a result, violations of the new rule could occur merely as the result of the passage of time and not as a result of any action by the employee or the company. The potential penalties are severe. An individual who intentionally or unintentionally violates the provision would be subject to immediate taxation on the entire deferred balance plus an additional 20 percent excise tax.

Although tax avoidance on deferred amounts is cited as the primary reason behind the proposal,[14] there is no avoidance of taxation under a nonqualified deferred compensation plan. Rather, tax is deferred until a future period. There is no tax consequence to deferrals into nonqualified plans because the matching principle applies, i.e., a deduction is only taken by the employer when the deferred amounts are actually received by the employee and taken into income. Furthermore, though we believe the proposal is aimed at large deferrals (although as explained later, it does not just pertain to large deferrals), it is unlikely that there will be a significant benefit from lower tax brackets when amounts are paid out. Since employment taxes

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[10] See Talley Inds., Inc. v. Commissioner, 116 F.3d 382 (9th Cir. 1997); Middle Atlantic Distributors, Inc. v. Commissioner, 72 T.C. 1136 (1979); see also Field Serv. Adv. 200210011 (Nov. 19, 2001).

[11] Letter to Sen. Charles Grassley from B. John Williams, Jr. Chief Counsel, Internal Revenue Service 4/1/03

[12] P.L. 108–357

[13] Senate Report 110–1, p.52

[14] Ibid

will typically be paid at deferral or when the amounts are no longer subject to forfeiture, there simply is no tax avoidance in play.

Nonqualified deferred compensation arrangements are used by many manufacturers to motivate and reward their workforce and to align the interests of employees with the interests of the company. Sometimes these plans are non-elective restoration plans, effectively restoring benefits to individuals that have been eliminated from tax qualified plans because of income limits. In other cases, these plans are used as supplemental retirement plans or incentive plans.[15] Still, in other cases, the decision to defer is a voluntary one, made by the employee under the rules of Section 409A. The Senate proposal 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. By voluntarily deferring compensation into a nonqualified plan, the employee gives up the right to receive that compensation and puts its eventual payment at the risk of the future performance of the company. If the plan offers the chance to invest the deferred funds in company stock, the alignment is even stronger. These arrangements should be encouraged, not restricted. The legislation enacted in 2004 adds safeguards to prevent employees from taking the deferred money and running when times are bad. As a result, employees who defer compensation know that if the company fails, it is unlikely they will ever receive those funds. This is a powerful corporate governance tool that aligns the interests of executives and shareholders.

The proposed limits on nonqualified deferred compensation also would have unintended consequences when applied to a typical supplemental pension plan that pays annual lifetime benefits in retirement. In many cases, the vesting of these benefits in a single year could push an employee's deferred compensation above the provision's annual cap, leaving the employee liable for an immediate tax and penalty on amounts they will receive over their lifetime. For example, the present value of a modest lifetime annuity payable at retirement could easily exceed the cap since the payment is assumed to continue as long as the retired employee lives. To avoid this problem, employers would have to pay the discounted value of the pension as a lump sum. Forcing lump sum payments would be bad pension policy and would remove a significant corporate governance benefit that is achieved when an employee is tied to the company for life.

It also is important to note that because the proposal would apply to amounts that exceed the lesser of the five-year average of an individual's taxable compensation or $1 million, it 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. Furthermore, the proposed limit on annual deferrals would act as a highly intrusive tax penalty on a company's fundamental business decision to pay employees through deferred rather than current compensation.

New Limits on Deducting Salary Payments

NAM members also have serious concerns about a provision in the Senate bill that would expand the definition of a covered employee under Section 162(m) of the tax code, which limits the deduction of salary payments. In recent years, the Joint Committee on Taxation[16] as well as a number of public and private sector witnesses before the Senate Finance Committee[17] has criticized this provision. In contrast, the Senate proposal would add a far-reaching new compensation limit to the tax code.

Section 162(m) currently denies an employer a deduction for non-performanced based compensation in excess of $1 million paid to an individual who is a "covered employee" of the employer, i.e., the taxpayer's chief executive officer ("CEO") or one of the four highest paid executive officers of the company at the end of the year (the "Top 4") whose compensation is required to be disclosed under the Securities and Exchange Commission's (SEC) proxy rules.[18]

In addition, the deduction limit applies if the non-performance-based compensation in excess of $1 million is paid to an individual who is a covered employee on

[15] Examples of affected plans are included in Attachment A and specific employee examples are included in Attachment B.

[16] "Present Law and Background Relating to Executive Compensation," Joint Committee on Taxation, JCX–39–06, 9/5/06

[17] Executive Compensation: Backdating to the Future, 9/6/06

[18] Note that, because the SEC recently amended the proxy disclosure rules to no longer include "the Top 4," Section 162(m) is no longer congruent with the proxy rules. "Executive Compensation and Related Person Disclosure; Final Rule and Proposed Rule" Federal Register Vol. 71, No. 174 (8 September 2006): 33–8732A.

the last day of the year in which the payment is made. Therefore, an employer might contractually commit to pay compensation to an employee on separation from service, at which time the employee would not be a "covered employee" under Section 162(m).

The Senate proposal would expand the definition of covered employee under Section 162(m) to include (i) any person who was CEO during any part of any year (not just the end of the year) and (ii) any person who ever was a "covered employee" in any year after 2006 (even if that person is not a covered employee in the year that the compensation payments are received or the year the services are performed). In effect, the proposal creates a new rule that if an employee is ever a covered employee, he will always be a covered employee—even if current compensation eliminated them from the "high five" of a corporation.

Under the proposal, compensation earned or payable in the future to an employee who at any time in a taxable year beginning after December 31, 2006, was a covered employee would remain subject to Section 162(m) in perpetuity. As drafted, this proposal represents a significant expansion of the scope of Section 162(m), rather than an attempt to close an inadvertent loophole.

The Senate proposal also modifies the definition of covered employee by dropping a cross reference to the securities law from existing Section 162(m). The SEC's new proxy rules (which apply to proxies filed for fiscal years ending on or after December 15, 2006), require detailed disclosure for any person who acts as CEO during the fiscal year, any person who acts as CFO during the fiscal year, and the three other most highly compensated executive officers other than the CEO and CFO. In order to retain the previous group for tax purposes (i.e., the CEO and the Top 4), the statutory change to Section 162(m) removes from the definition of "covered employee" a requirement that "the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934." This approach has serious unintended consequences and may significantly and inadvertently expand the category of employees who may be covered.

In addition, as drafted, the proposal would be retroactive, denying corporations' deductions for compensation that was earned before 2007, by any employee who becomes a covered employee after 2006. Many employers today have outstanding compensation obligations that were structured in reliance on current law, but that would become non-deductible under the proposed amendment. Unfortunately, there is little or nothing a corporation could do to protect the deduction it thought it already had—existing contractual arrangements are legally binding on the employer and cannot simply be rewritten by the employer to reflect an unanticipated retroactive change in law.

By denying a deduction for pre-2007 compensation an employer is obligated to pay, the proposal will raise taxes on corporate employers without changing corporate compensation practices. While a retroactive application of the new rule will not affect executives who will be paid what they are owed, corporate shareholders stand to lose because of the corporation's tax increase. Note that this was not the case when Section 162(m) was originally enacted and Congress expressly grandfathered all compensation payable under written binding contracts that were already in effect.

While we oppose enactment of the changes to Section 162(m), if these changes are made they should only apply prospectively since employers cannot control past compensation arrangements. At a minimum, the proposal should expressly provide that amended Section 162(m) will only apply to tax years beginning after the date of enactment and will not apply to any compensation to which an employee had a legally binding right, whether or not contingent, on or before the last day of the taxable year including [the date of enactment] or which relate to services performed before such last day.[19]

The NAM also believes that delinking Section 162(m) from proxy rules is not in the public interest. Current law defines a covered employee by reference to the SEC's proxy rules. This makes sense for two reasons. It is easier for taxpayers (and the IRS) to figure out who is a covered employee in advance of paying compensation. In addition, it targets the rule to *"executive officers"* of a company within the meaning of the Securities Exchange Act, i.e., officers who have policy-making functions and therefore arguably can influence their own compensation.

Based on legislative history,[20] the proposal is intended to "delink" the definition of a "covered employee" from the definition used by the SEC as a result of changes in the SEC's proxy rules. The SEC has recently revised the proxy rules to now cover

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[19] The effective date of the proposal should permit public companies time to obtain shareholder approval of performance-based plans that may need to be modified.

[20] Senate Report 110–1, p.68

the CEO, the CFO and the next three most highly compensated employees. The policy reason for "delinking" is not clear. As drafted, the proposal represents a significant expansion of the scope of Section 162(m) to cover employees with no policy-making authority who are not in a position to influence their own compensation and ambiguity as to what compensation counts for determining whether an employee is one of the "Top 4".

The proposal also deletes references in Section 162(m) to "total compensation . . . for the taxable year [that] is required to be reported to shareholders under the Securities Exchange Act of 1934." Accordingly, proposed changes to Section 162(m) could be read to apply to all "officers" of an employer, even those with no policy-making authority. Neither Section 162(m) nor the Senate proposal defines the word "officer," thereby creating ambiguity where none exists today. SEC proxy disclosure is limited to "executive officers," which means those officers who have significant policy-making authority for the issuer. We do not believe that the proposal was intended to broaden the scope of covered employees in this way and urge that, if enacted, Congress clarifies the proposal to state that covered employees continue to include only executive officers for whom proxy disclosure could be required.

In addition, while the proposal provides that the four "highest compensated" officers in the year would be covered, it does not specify a definition of "compensation." Under current law, that answer is well understood by corporations because a "covered employee" is determined by reference to the SEC's proxy rules. New SEC rules capture executive officers' total compensation for each year, including equity awards and deferred compensation, which may not be taxable until several years in the future. By deleting the reference in Section 162(m) to the SEC's proxy rules, the Senate proposal leaves no definition of compensation whatsoever.

In sum, the NAM strongly believes that corporate governance issues—like executive compensation—should be addressed through corporate governance changes, not through the tax code.

New Tax on Ex-Pats

Among the revenue-raisers in the Senate proposal is a little noticed but potentially devastating provision that would change the rules for taxation of foreign persons who are long-term residents of the United States and are leaving the country. The provisions would levy a new "mark-to-market" tax on the unrealized appreciation in all their property, on the day before expatriation. In effect, the expatriate is treated as having "sold" all his or her property, for its fair market value, on the day before expatriation. Property subject to the provision includes personal property, interests in qualified retirement plans, and interests in nonqualified trusts.

This provision could have a significant negative impact on resident aliens employed by U.S. manufacturers. For example, a resident alien who has worked for a U.S. company and decides to return to his or her home country to retire or for other business or personal reasons could find the value of their assets significantly eroded—especially if there is an acceleration of tax payable on 401(K) or other retirement accounts.

Finally, another general concern of NAM members is the inclusion of retroactive tax provisions in the Senate bill as well as other tax legislation. It has long been the position of the NAM that a retroactive imposition of taxes is fundamentally unsound and unfair.

In sum, NAM members believe strongly that tax relief will go a long way to ensuring that our economy keeps growing. Conversely, tax increases, like those outlined above, will negate much of the positive impact of tax relief and, in some cases, threaten continued economic growth. We appreciate the opportunity to present our views on these issues to the committee and we thank you in advance for rejecting these revenue raisers.

Attachment A

Examples of Benefit Plans and Company Types Affected by Section 226

Restricted Stock Units: In recent years, many employers have redesigned their equity programs to increasingly rely on the use of restricted stock units (RSUs). Typically, employees 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. 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. Some RSU programs fit within the regulatory exception from 409A for compensation that is paid upon vesting (or within 2½ months after the year of vesting.) It is not uncommon, however, for employers to find that their RSU program does not meet the short-term deferral exception and that compensation paid under the program is subject to 409A. In

some instances, an employee may vest in the RSUs in increments over the performance period but is not paid until full vesting is attained at the end of the performance period. In other instances, an employee may vest fully upon reaching a specified retirement age during the performance period. Under the legislation, such RSU grants would be subject to the one-time pay limit and could cause employees to exceed the limit.

For example, a newly hired employee of a Fortune 500 company receives a grant of RSUs that is subject to 409A. The employee is granted 6,000 RSUs at a time when the value of the company's stock is $30 (i.e., value of the grant is $180,000). The employee is scheduled to vest in ⅕ of the RSUs each year over a 5-year performance period. The employee receives a base salary of $140,000, which under the Senate provision would be the employee's one-time pay limit for the first year. Because the value of the RSU grant exceeds the one-times pay limit, a 409A violation would occur and the employee would be subject to a 20 percent additional tax on the value of the RSUs as they vest (i.e., 20 percent of the RSUs per year) over the 5-year period.

Because "earnings" on the underlying shares of the company's stock also are subject to the limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the RSUs increased beyond the limit.

For example, an employee is granted 1,000 RSUs at the beginning of employment with a technology company. The employee "vests" in these units after 5 years of service and the RSUs are designed to pay out after 10 years. The employer believes that this plan aligns the employee's interest with growing the company value rather than maximizing current salary. At the beginning of employment, the RSUs were valued at $15 per share. The employee earns approximately $100,000 per year and receives modest increases (based on CPI of 3 percent). The employee's 5-year average taxable compensation from the company is $110,000 at the end of year 5. The company stock price stays relatively flat, but in year 6 the company becomes highly successful and the valuation of the stock takes off eventually to exceed 10 times the original price. The one-times-pay limit would be exceeded because the increase in the RSU value in year 6 will exceed $110,000.

Supplemental 401(k) Plans: 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 plan as additional deferrals that count against the one-time pay limit and could cause the employee to exceed the limit.

For example, a Fortune 500 company offers a nonqualified supplemental plan to certain employees, including mid-level management employees receiving approximately $150,000 to $200,000 per year in total wages from the company. Many of these mid-level management employees are long-serving employees who typically defer 20 to 40 percent of their wages. Employees who participate in the plan receive a small matching contribution (typically between $3,000 and $6,000) from the company based on their deferrals. Investment earnings are credited to an employee's bookkeeping account in the plan based upon deemed investments chosen by the employee from among the same mutual funds as those offered in the company's 401(k) plan. Using 2006 data, the company has calculated that at least seven such employees would have exceeded their 5-year average taxable compensation. The following chart summarizes the relevant information:

Emp.	Years of Service	2006 Total Wages	5-year Average Taxable Wages	Account Balance As of 12/29/06	2006 Deferrals And Match	2006 Investment Earnings	Total Deferrals	Deferrals Above 5-year Avg Limit
1	27	$159,500	$ 90,180	$418,400	$ 66,700	$ 72,300	$139,000	$48,820
2	13	$175,400	$102,220	$508,300	$ 60,800	$ 52,500	$113,300	$11,080
3	28	$179,300	$ 62,380	$364,100	$116,400	$ 27,000	$143,400	$81,020
4	25	$178,300	$126,920	$614,700	$ 47,900	$109,100	$157,000	$30,080
5	30	$183,700	$126,040	$617,700	$ 38,000	$141,800	$179,800	$53,760
6	14	$194,400	$128,020	$486,500	$ 62,200	$ 73,200	$135,400	$ 7,380

Emp.	Years of Service	2006 Total Wages	5-year Average Taxable Wages	Account Balance As of 12/29/06	2006 Deferrals And Match	2006 Investment Earnings	Total Deferrals	Deferrals Above 5-year Avg Limit
7	6	$203,000	$ 92,020	$647,100	$ 76,300	$ 94,700	$171,000	$78,980

Since earnings that are tied to a publicly-traded investment are often very unpredictable, employees would have to leave a large cushion below the one-time pay limit to take into account potential earnings. An employee who participates over a number of years could easily exceed the one-time pay limit solely because of earnings.

For example, assume employee 5 in the above example stopped making deferral elections after 2006, and that the employee receives modest increases in wages each year (based on CPI of 3 percent). Also assume that the employee elected to have all of his account balance as of December 29, 2006 ($617,700) be deemed invested in the plan's S&P 500 index fund, and that for the 4-year period from 2007 to 2010 that fund's annual return was 20 percent per year (which would be consistent with the S&P 500's performance in the late 1990s). By 2010, there would be a 409A violation solely because the "earnings" credited to the employee's bookkeeping account ($213,477) exceeded the employee's 5-year average taxable compensation from the company ($189,376).

Supplemental Pension Plans: Some companies maintain supplemental pension programs to serve as retention tools and assist management employees in saving for retirement. 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 incent employees to stay in their jobs. The legislation would require employers to change or abandon these arrangements because later-year accruals may exceed the one-time pay limit 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 pension 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-time pay limit to be exceeded.

For example, one Fortune 500 company sponsors a supplemental pension plan that is available to middle managers making a little over $100,000 per year, many of which work for the company's retail entity. The company noted the difficulty in calculating annual accruals for this type of plan and the fact that the value of annual accruals often varies significantly from year to year due to interest rate changes and eligibility for early retirement. To the extent an accrual under the supplemental pension plan exceeded the limit, it is not clear how the company could "fix" the pension plan formula to avoid an excess accrual. The company also noted that the impact of the one-time pay limit would be even more severe because other forms of compensation provided to these managers, such as RSUs, performance units and severance pay, would also be aggregated with accruals under the supplemental pension plan in applying the limit. As a result, the company advised us that they may discontinue the supplemental pension plan if the annual limit is enacted.

Another Fortune 500 company provides a supplemental pension plan to its key executives (about 4,000 U.S. employees). The covered employees do not elect into the plan, it is provided automatically. The assets are also at a substantial risk of forfeiture until the employee reaches age 60. If an employee leaves the company before age 60, he or she receives nothing from the plan. The plan benefit is unfunded before and after an employee attains age 60. It is paid out on retirement as a life contingent annuity (either single life or joint & survivor) with a five year guarantee. The Senate proposal appears to apply to the supplemental pension plans at the time the plan vests (i.e. at age 60). Under the plan, until an employee reaches age 60, the benefit is subject to a substantial risk of forfeiture. At age 60, the benefit is vested and also deferred, since the employee has no choice but to defer payment of the vested benefit as a life annuity when that employee retires. The amount of the deferral at age 60 presumably would be the then present value of the life annuity. A modest lifetime annuity viewed that way would violate the $1 million cap and the employee would be subject to a regular income tax and 20 percent penalty tax that would significantly reduce their benefit.

For other employers whose supplemental pension plan may follow the vesting schedule of their qualified plan, the situation is more acute. In such a case, the vested annual accrual is likely to be subject to the new limitations. The calculation of that amount (which can depend upon salary levels and incentive compensation payouts) may be impossible until after the fact, meaning that the employee will never know, until it is too late, whether he has "deferred" too much.

Bonuses and Incentive Programs: Many employers structure their bonus programs to fit within the regulatory exception from 409A for compensation that is paid upon vesting (or 2½ months after the year of vesting.) It is not uncommon, however, for employers to find that they cannot meet this strict 2½ 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 payment being subject to 409A. Some employers may need to wait longer for performance criteria to be ascertained, financials certified, etc., resulting in the payment being subject to 409A and the one-time pay limit. In other instances, an employee may vest in increments over the performance period or upon reaching retirement age but is not paid until the end of the period, which also would result in the payment being subject to 409A and the one-times pay limit. Finally, employers may, to align their interests with those of their managers, encourage or allow that bonuses be deferred until retirement rather than being paid currently. Section 409A specifically allows for voluntary deferral of performance-based pay. The new limits would make such a voluntary deferral difficult and often impossible.

Private Equity: Many private companies (including start-ups) cannot readily conform to the specific administrative rules provided under the 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. Under the Senate bill, private companies could not provide this type of equity grant to employees unless the grant does not exceed the one times pay limit. Because "earnings" on the equity also are subject to the proposed limit, employees could have a tax penalty under 409A merely because the company was successful and the value of the equity increased beyond the limit.

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 Senate bill limits the business from making any promise that exceeds one-time pay for employees.

Attachment B

Real Examples of Employees Affected by Section 226

Asian male manager, age 57

Base Salary: $180,500
Average 5-year W–2: $142,000
Bonus deferral (deferred in 2006 by irrevocable election made in 2005): $59,000
SERP earnings (not payable until after termination by irrevocable distribution election): $80,000
Deferred Compensation earnings (irrevocable distribution election): $6,500
Total 2006 "deferrals": $145,500
Amount above allowance: $3,500

Presumably, this would mean a 20% excise tax plus the income tax on the entire amount.

Caucasian Female manager, age 50

Base Salary: $197,000
Average 5-year W–2: $144,000
Bonus deferral (deferred in 2006 by irrevocable election made in 2005): $72,000
SERP earnings (not payable until after termination by irrevocable distribution election): $75,000
Deferred Compensation earnings (irrevocable distribution election): $8,000
Total 2006 "deferrals": $155,000
Amount above allowance: $11,000

Presumably, this would mean a 20% excise tax plus the income tax on the entire amount

Supplemental Sheet

Witness:

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Statement of U.S. Chamber of Commerce

The U.S. Chamber of Commerce, the world's largest business federation representing more than three million businesses and organizations of every size, sector, and region, is pleased to have the opportunity to express our views on the revenue-raising provisions contained in the Senate-passed version of H.R. 2, the "Small Business and Work Opportunity Act of 2007."

The Chamber strongly opposes the permanent tax increases used to offset the cost of the Senate legislation. The denial of deductions for settlements and punitive damages would discourage the out-of-court settlement of legal cases and will increase the burden on the judicial system. Imposing limitations on non-qualified deferred compensation interferes unnecessarily in the management labor market and retroactive changes to the Tax Code unfairly penalize companies for engaging in legal behavior. Together, these provisions run counter to the goal of promoting economic growth and job creation.

Disallowance of Tax Deductions for Government Settlements

Increased Burden on Judicial System. This proposal runs counter to the goal of settling disputes without litigation and will increase the volume of cases in our court system. It would impose a chilling effect on the ability and willingness of parties to settle cases that would not ultimately merit prosecution to a conclusion. The blanket denial of otherwise allowable tax deductions for settlement of potential violations of laws, or mere investigations of such, is overly broad and unfair.

Reduction in Settlement Amounts. The proposal likely will have the perverse impact of lowering settlement recoveries if such settlements are nondeductible or if there is uncertainty regarding what portion of settlements may be deductible.

Overturns 30 years of Precedent. The proposal turns 30 years of well-established policy as to what are deductible settlement payments and what are fines and penalties on its head. Under this provision, the regulatory agency always is right and the payment always is non-deductible unless a company can prove it is making payments directly to the specific persons harmed. This narrow definition of restitution is not in sync with long-established current law allowing restitution to cover a class of similarly situated persons.

Limitations on Non-qualified Deferred Compensation

Deferred Compensation is not Executive Compensation. Deferred compensation is a contractual agreement under which the employee elects to defer current payment. These arrangements apply to multiple management levels—not just the top executives—who, for various reasons, may be limited in the amounts that they can save in qualified plan arrangements.

Additional Changes to Deferred Compensation are Premature. The Treasury Department has yet to release final regulations interpreting the 2004 statute due to the complexity of these issues. Including new provisions at this time will only add to the uncertainty about the application of Section 409A. In addition, the Securities and Exchange Commission recently issued regulations requiring enhanced disclosure of executive compensation generally. The impact of these changes has not yet been realized and additional changes at this time are premature at best.

Arbitrary Compensation Limits are Bad Tax Policy. In a 2003 report, the Joint Committee on Taxation concluded that Code section 162(m), which limits cash compensation, is "ineffective at accomplishing its purpose [and] overrides normal tax principles." Accordingly, the imposition of similar restrictions on nonqualified deferred compensation does not address the perceived abuses and would similarly be bad policy.

Retroactive Tax Increases

Unfairly Penalizes Legal Behavior. The companies that would be affected by the retroactive Sale-In Lease-Out and corporate inversion proposals were engaged in perfectly legal behavior at the time. Congress had previously passed legislation to limit these transactions. Adopting the Senate position would unfairly change the tax rules after the fact.

Increase Uncertainty for Business Planning. The business community requires predictability in order to plan appropriately. The proposed retroactive changes require companies to second-guess congressional intent and create unnecessary uncertainty, which run counter to the goal of producing a stable economic environment.

Erodes Faith in the Tax System. Changes to the tax code should not be made lightly absent strong policy considerations. The Senate bill would further modify changes to the tax code that were passed by Congress in 2004. Repeated changes to the same provisions of our tax laws erode their reliability and stability.

Statement of Working Group for Certainty in Settlements

On behalf of the thousands of businesses we represent, we appreciate the opportunity to express our strong opposition to Sections 223 and 224 of the Senate-passed version of H.R. 2, the "Small Business and Work Opportunity Act of 2007." As Chairman Rangel stated, "the Senate tax relief package includes a number of revenue-raising provisions that would have a significant impact on the business community." Because of significant negative impacts, the Working Group for Certainty in Settlements strongly opposes Sections 223 and 224.

The denial of deductions for punitive damages by Section 223 runs counter to 30 years of strong public policies and applies principles of tort law to the tax code. Section 223 will have not only a significant negative impact on the business community by forcing them to spend more resources litigating claims, but will also adversely affect victims by reducing the likelihood of prompt settlement and forcing more cases to lumber through trial. This will also increase litigation costs for states. Finally, disallowing a deduction for payment of punitive damages, and requiring insurance proceeds to be taxed as income, will add unnecessary and unmitigated strains on United States taxpayers. As such, Section 223 should be removed from H.R. 2.

Similarly, the Working Group for Certainty in Settlements strongly opposes Section 224 of H.R. 2. As passed by the Senate, Section 224 would deny a deduction for all types of settlements that currently are entered into in the normal course of business. Consequently, ordinary and necessary business expenses that, under the well-established principles of taxation, are not considered fines or penalties would now be non-deductible under this provision. Worse, Section 224 would deny a deduction for any such payments, including those where there is no admission of guilt or liability. Accordingly, Section 224 should also be removed from H.R. 2.

I. Section 223, Denial of Deduction for Punitive Damages

Section 223 would have a significant impact on business by denying any deduction for punitive damages that are paid or incurred by the taxpayer as a result of a judgment or in settlement of a claim. If the liability for punitive damages is covered by insurance, any such punitive damages paid by the insurer would be included in gross income of the insured person and the insurer would be required to report such amounts to both the insured person and the Internal Revenue Service ("IRS"). Section 223 runs counter to 30 years of legislative history and strong public policies. If enacted, the provision will have significant negative effects on the business community and injured victims. Finally, disallowing a deduction for payment of punitive damages and requiring insurance proceeds to be taxed as income, will implement a harmful "double-tax" on United States taxpayers.

A. Background on Deductible Business Expenses

The Internal Revenue Code allows the taxpayer a deduction for all ordinary and necessary expenses that are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business.[1]ness expenses are the cost of carrying on a trade or business. Current law allows amounts paid by a taxpayer as punitive damages that arose as a result of the ordinary conduct of its business activities to

[1] 26 U.S.C. § 162(a).

be deductible as an ordinary and necessary business expense. This provision is a result of Congressional action and IRS guidance.

In 1969, Congress, through codification of *Tank Truck Rentals, Inc. v. Commissioner,*[2] recognized that public policy restricts deductions for certain business expenses.[3] However, Congress expressly limited the denial of deductions on public-policy grounds to a limited group of expenditures. Section 162(f) denied deductions of fines and penalties.[4] Section 162(g) denied deduction for a portion of treble damage payments resulting from a criminal conviction under the antitrust laws. Section 162(c)(1) denied deductions for bribes paid to public officials.[5] Finally, Sections 162(c)(2) and (3) denied deduction for other unlawful bribes or kickbacks.[6] In the accompanying Senate Finance Committee report, the Committee stated "the provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."[7]

Later, in 1980, the IRS issued a revenue ruling clarifying whether the amounts paid as punitive damages that are incurred in the ordinary conduct of the taxpayer's business operations are deductible as an ordinary and necessary business expense.[8] A revenue ruling is a "written statement issued to a taxpayer or his authorized representative by the National Office which interprets and applies the tax laws to a specific set of facts."[9] There, a company was sued by another corporation for acts and contractual violations perpetuated in the ordinary conduct of its business activities. The IRS wrote that if the issues were not based on any prohibited activities outlined in § 162, then the judgment, including amounts identified as punitive damages, were an ordinary and necessary cost of doing business.

B. Impact of Section 223 on the Business Community and Public Policy

The deductibility of punitive damages is also rooted in strong public policies. It is a reflection that no product can be absolutely safe. The worst effects of Section 223, however, may be felt by the injured. The ability of taxpayers to deduct punitive damages encourages settlement which makes the victim quickly whole. Additionally, requiring insurance proceeds to be taxed as income to the extent such proceeds are used to pay for punitive damages further increases the actual costs of any settlement thereby reducing the likelihood that cases will settle short of trial. Discouraging settlement in our already overheated and strained court systems makes little sense for at least three reasons.

First, Section 223 would apply principles of strict product liability to the tax code. This legal theory provides that an injured plaintiff need only show that a company, regardless of its level of care, sold a defective product and that the product proximately caused the plaintiff's injuries. This principle, having grown since the 1960s, has made it substantially easier for plaintiffs to recover damages. Under this theory, United States companies must operate in a world where no product is or can be absolutely perfect. Examining the issue, the Congressional Budget Office reported that "such high costs sometimes have perverse negative effects on safety, they argue—for example, by discouraging firms from conducting safety research that could create a legal 'paper trail' or by raising the prices of risk-reducing goods and services, such as medical care. Critics also contend that plaintiffs frequently bring frivolous lawsuits when they know that the defendant is inclined to settle out of court to avoid the costs of litigation."[10] Applying these principles of strict liability to the tax code will only further hamper entrepreneurship, innovation, and product development. As such, Section 223 should be removed from H.R. 2.

Second, Section 223 will discourage settlements in an already overburdened judicial system and negatively affect the injured. Under current law, companies may settle their cases without admitting guilt. In many cases involving products regulated by the Food and Drug Administration or the United States Department of Agriculture, for example, having to admit guilt would have extremely harsh business ramifications. Having the costs be non-deductible may be deemed to many businesses as tantamount to an admission of guilt and may discourage many of these

[2] Tank Trunk Rentals, Inc. v. Commissioner, 356 U.S. 30 (1958).
[3] The Tax Reform Act of 1969, Pub. L. No. 91–172, § 902, 83 Stat. 487, 710–711.
[4] 26 U.S.C. § 162(g).
[5] Id at § 162(c)(1).
[6] Id at §§ 162(c)(2) and (3)
[7] S. Rept. 91–522 at 274, 91st Cong., 1st Sess. (1969).
[8] Rev. Rul. 80–211; 1980–2 C.B. 57.
[9] 26 C.F.R. § 601.201(a)(2).
[10] "The Economics of U.S. Tort Liability: A Primer," chapter 1 (Congressional Budget Office October 2003), available at http: // www.cbo.gov / showdoc.cfm?index =4641&sequence=2.

settlements. Because of this, Section 223 will discourage efforts to make victims whole. Current law allows a company to deduct settlement payments, thereby encouraging companies to spend fewer resources litigating claims and to make victims whole as quickly as possible. Allowing companies to deduct all settlement payments as an ordinary business expense resulting from events undertaken in the ordinary course of business (outside of punitive damages for wrongdoing) encourages a rapid and cost-efficient response to genuine claims. As enactment of Section 223 will effectively drive up settlement costs, thereby prolonging litigation and discouraging settlement, it should be removed from H.R. 2.

Third, removing the deduction for payment of punitive damages, and requiring insurance proceeds to be taxed as income to the extent such proceeds are used to pay for punitive damages, will unnecessarily strain the corporation, its shareholders, and the economy by taxing the corporation on unearned income. Also, Section 223 will force the corporation to pay such taxes out of its cash reserves, thereby reducing the shareholders' value in the corporation. This policy basically penalizes the company thrice for the same act. First the court slaps punitive damages on the company. Second, the corporation is also forced to pay tax out of pocket on any insurance payments. Third, the payment to the plaintiff will not be deductible to the company. This will significantly increase how much a company has to pay for any punitive damage award. As Section 223 will tax insurance proceeds as income, it will increase the penalty to the corporation, without benefiting the injured party. It will also increase the costs to the States by forcing more cases to go to trial. Indeed, the only beneficiary would be the federal government, and we believe that the added increase in tax revenues will be far less than the added costs incurred by the states in trying the additional cases. As such, Section 223 should be struck from H.R. 2.

II. Section 224, Denial of Deduction for Certain Fines, Penalties and Other Amounts

Section 224 would have a significant negative impact on businesses by radically modifying the rules regarding the deductibility of fines and penalties. This significant extension would deny a deduction for all types of positive settlements that are currently entered into in the normal course of business. As such, the Working Group for Certainty in Settlements strongly opposes Section 224 of H.R. 2.

A. Background on Deductions for Fines and Penalties

In 1969, Congress specifically limited the deductibility of payment for certain fines or penalties to a government for the violation of law.[11] Specifically, implementing regulations provide that the following fines and penalties are not deductible as legitimate business expenses: (1) amounts paid pursuant to a **conviction** or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding; (2) amounts paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties; (3) amounts paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or (4) amounts forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.[12]

B. Impact of Section 224 on the Business Community and Public Policy

Congress correctly denied the deduction as a business expense for the payment of certain fines or penalties to a government for the violation of law. However, Section 224 of H.R. 2 would radically modify these rules by providing that amounts paid or incurred (whether by suit, agreement, or otherwise) to a government for the violation of any law or the investigation or inquiry into the potential violation of any law are nondeductible, even if these payments are not fines or penalties. While we strongly support measures to combat corporate wrongdoing, this provision will have significant unintended and negative impacts on the business community, government agencies, and nongovernmental regulatory entities by reducing the likelihood of prompt settlements and forcing more litigation.

Beyond the extension of listed fines and penalties to nearly all "fines, penalties, and other amounts," the Working Group for Certainty in Settlements is extremely concerned with the "guilty until proven innocent" nature of Section 224. As passed by the Senate, the provision denies a deduction for any such payments, including those where there is no admission of guilt or liability and those made for the purpose of avoiding further litigation. Rather than providing clarity and certainty, Section 224 would deny a deduction for all types of settlements that are positively entered into in the normal course of business and are more properly and logically

[11] 26 U.S.C. § 162(f).
[12] 26 C.F.R. § 1.162–21 (emphasis added).

viewed as remediation rather than punishment. For example, the following types of settlements are illustrative of the types of costs companies incur in the ordinary course of business that might no longer be deductible if this provision were to become law: rate refunds made by regulated utilities; rate case settlements for alleged violations of tariff; royalty settlements; automobile manufacturer costs associated with safety recalls; bank examination fees that banking institutions, as a regulated industry, are required to pay; and, EPA information requests which are routinely sent to companies. It appears Section 224, if enacted, would deny the deductibility of all these expenses.

The Working Group for Certainty in Settlements strongly opposes the non-deductibility of nearly all "fines, penalties, and other amounts" paid by taxpayers regardless of whether the actions were the result of actual wrongdoing or not. Because of this, Section 224 will significantly interfere with the regulatory system by increasing the incentive for companies to force regulatory agencies to prove up their cases at formal hearings, as now required in many instances by the Administration Procedure Act.[13]

III. Conclusion

The Working Group for Certainty in Settlements urges elimination of Sections 223 and 224 of the Senate-passed version of H.R. 2, the "Small Business and Work Opportunity Act of 2007." Both Sections would remove certainty from the tax code, run counter to strong public policies, and further strain already overtaxed United States corporations.

We appreciate your consideration of our views on Sections 223 and 224. We look forward to continuing to work with you and your staff to develop tax policy that encourages economic growth and helps us better compete in the global marketplace.

The Working Group for Certainty in Settlements
American Chemistry Council
American Petroleum Institute
American Tort Reform Association
Associated Builders and Contractors
Association of American Railroads
Business Roundtable
Edison Electric Institute
The Financial Services Roundtable
National Association of Manufacturers
National Association of Mutual Insurance Companies
National Foreign Trade Council
Securities Industry and Financial Markets Association
Small Business and Entrepreneurship Council
U.S. Chamber of Commerce

[13] 5 U.S.C. § 554 *et seq*.