



One Minute Memo™

Senate Votes to Increase Taxes on Executive Compensation

Late last week the Senate approved amendments to the House's proposed Fair Minimum Wage Act of 2007 (Minimum Wage Act) which could dramatically increase taxes on nonqualified deferred compensation and limit corporate tax deductions for many forms of executive compensation.

The Minimum Wage Act, passed by the House on January 10, 2007, would increase the minimum wage to \$7.25 over two years. Senate amendments to the Minimum Wage Act provide, among other things, tax incentives intended to reduce the burden of the wage increase on small businesses. The Senate's amendments include revenue-generating provisions to cover the proposed tax-breaks, two of which would directly impact compensation arrangements as summarized in the charts below:

<i>Proposed Tax Increase on Deferred Compensation Amounts</i>	
Application	The proposal applies to amounts deferred under nonqualified deferred compensation arrangements as defined under IRC Section 409A, including plans of both private organizations and publicly-held corporations.
Annual Deferral Limitation	<p>If annual aggregate amounts deferred after 2006, including earnings on such amounts, exceed the lesser of:</p> <ul style="list-style-type: none"> • \$1 million, or • An individual's 5-year average annual taxable compensation (generally determined as of the year preceding the deferral year), <p>then the excess is subject to taxation as if earned under a deferred compensation plan that does not comply with 409A.</p>
Tax for Exceeding Limit	Present-law sanctions for failure to satisfy IRC Section 409A apply: the deferred compensation amounts and vested earnings are includible in income, and amounts are subject to an additional 20% tax and an interest penalty.

<i>Proposed Tax Increase on Deferred Compensation Amounts</i>	
Proposed Effective Date	January 1, 2007. (There will be some relief to allow existing outstanding deferral elections to be modified on or before December 31, 2007.)
Implications if Enacted	<ul style="list-style-type: none"> • Companies will need to immediately tally and review all forms of nonqualified deferred compensation. • Depending upon regulations, the law could force companies to curtail the use of restricted stock units and phantom stock, as well as traditional forms of nonqualified deferred compensation. • Will require close monitoring of annual deferrals and earnings. • Any desire to gross-up executives for taxes must be thoughtfully balanced with institutional investor proxy voting guidelines, potential adverse publicity, and proxy optics.

<i>Proposed Broader Limits on Public Company Tax Deductions</i>	
Application	<p>The proposal expands the definition of “covered employee” under IRC Section 162(m) for purposes of limiting the tax deduction for non-performance based compensation to \$1,000,000 per executive per year to include:</p> <ul style="list-style-type: none"> • The CEO or any individual acting in the capacity of CEO at any time during the taxable year (vs. at the close of the taxable year), • Former covered employees, and • A beneficiary of a covered employee.
Proposed Effective Date	Company tax years beginning January 1, 2007. (No express exception for existing agreements.)
Implications if Enacted	<ul style="list-style-type: none"> • Would unlink definition of covered employee from definition of “named executive officer” for proxy purposes, and require separate tracking. • Unlike current law, once an executive becomes a covered employee he or she will always be treated as such. • Could cause companies to limit traditional forms of deferred compensation and severance, and rely more on cash-based performance plans, stock options, and performance-based equity arrangements.

Prospects for Legislation.

Joint House and Senate negotiations should begin soon but could take weeks. Tax legislation traditionally originates in the House. Some House members have objected to the Senate's amendments (which also include immigration reform) on procedural grounds. Other House members desire a straight up or down vote on a minimum wage bill as part of an accelerated 2007 legislative agenda. President Bush has indicated he would veto a minimum wage bill without tax cuts. As an increase in the minimum wage is a high priority for many in the House and Senate, one should expect a compromise that includes elements from the Senate version

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