STATEMENT OF
THE ERISA INDUSTRY COMMITTEE
ON THE DEFERRED COMPENSATION PROVISIONS
IN THE SENATE-PASSED VERSION OF H.R. 2

SUBMITTED TO
THE COMMITTEE ON WAYS AND MEANS
OF THE
U.S. HOUSE OF REPRESENTATIVES

FOR THE COMMITTEE'S HEARING ON THE
REVENUE INCREASING MEASURES IN
THE SENATE-PASSED VERSION OF H.R. 2

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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.