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SMALL BUSINESS AND WORK OPPORTUNITY ACT OF 2007

January __, 2007.—Ordered to be printed

Mr. BAUCUS, from the Committee on Finance,
submitted the following

REPORT

together with
ADDITIONAL VIEWS

[To accompany S. _____]

The Committee on Finance, having considered an original bill, S. _____, to amend the Internal Revenue Code of 1986 to provide additional tax incentives to employers and employees of small businesses, and for other purposes, reports favorably thereon and recommends that the bill do pass.

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**F. Limit Amounts of Annual Deferrals Under Nonqualified
Deferred Compensation Plans
(sec. 206 of the bill and sec. 409A of the Code)**

Present Law

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.⁷⁸ The requirements include rules relating to distributions, acceleration of benefits and funding. For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. In general, elections to defer compensation for a taxable year must be made not later than the close of the preceding taxable year. Section 409A does not include rules limiting the amount that may be deferred under a nonqualified deferred compensation plan.

A nonqualified deferred compensation plan generally includes any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE. A qualified governmental excess benefit arrangement (sec. 415(m)) and an eligible deferred compensation plan (sec. 457(b)) is a qualified employer plan.

If the requirements of section 409A are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

Under present law, Treasury is authorized to prescribe regulations as are necessary or appropriate to carry out the purposes of the provision.

Reasons for Change

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.⁷⁹

⁷⁸ Code sec. 409A.

⁷⁹ See, e.g., Ellen E. Schultz and Theo Francis, *As Workers' Pensions Wither, Those for Executives Flourish*, WALL ST. J., June 23, 2006, at A1, and *Deferring Compensation Also Creates A Company Debt to Executives*, June 23, 2006, at A8. Theo Francis, *'Phantom' Accounts for CEOs Draw Scrutiny*, WALL ST. J., June 13, 2005, at B1.

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. The Committee believes that the amount of compensation that can be deferred to avoid the payment of tax should be limited.

Explanation of Provision

The provision adds an additional requirement to the rules governing the income inclusion of amounts deferred under a nonqualified deferred compensation plan. Under the provision, the annual aggregate amounts deferred under a nonqualified deferred compensation plan by an individual may not exceed the applicable dollar amount for the taxable year. The applicable dollar amount is the lesser of (1) \$1 million or (2) the average annual compensation payable during the base period to the participant by the employer maintaining the nonqualified deferred compensation plan (or a predecessor or related entity) and which was includible in the participant's gross income for taxable years in the base period. Earnings (whether actual or notional) attributable to nonqualified deferred compensation are treated as additional deferred compensation and are subject to the provision. Thus, such amounts are taken into account in determining whether the limit on the amount deferred is exceeded.

If the requirement is not satisfied, the present-law sanctions for failure to satisfy section 409A apply. Thus, if the requirement is not satisfied, all amounts deferred under the nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. If the requirements of the provision are not satisfied, as under present law, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.⁸⁰

Earnings (whether actual or notional) in a subsequent taxable year on amounts included in income under the provision are includible in income in such subsequent taxable year to the extent such earnings are not subject to a substantial risk of forfeiture and not previously included in gross income. The present-law sanctions under 409A (interest at the underpayment rate plus one percentage point and a 20-percent additional tax) also apply.

The base period is the five taxable year period ending with the taxable year preceding the taxable year for which the limitation is being determined (the "computation year"). If, before the beginning of the computation year, an election is made to defer compensation for services performed in the computation year, the base period is the five taxable year period ending with the taxable year preceding the taxable year in which the election is made. For example, suppose an executive elects in 2008 to defer a portion of compensation to be earned in 2009. The base

⁸⁰ These consequences apply under the provision to amounts deferred after the effective date of the provision.

period for the 2009 computation year would be 2003 to 2007. In the case that the individual does not perform services for the employer for the entire five-year period, the base period is the portion of such period during which the individual performs services for the employer (or a predecessor employer). It is intended that the Secretary of Treasury issue guidance similar to that under section 280G regarding the base period determination in cases in which the individual does not perform services for the employer for the entire five-year period.

As under section 409A generally, except as provided by the Secretary, aggregation rules similar to the rules under section 414(b) and (c) apply. In addition, all nonqualified deferred compensation plans maintained by all employers treated as a single employer under these aggregation rules are treated as one plan.

The provision applies to all amounts deferred under nonqualified deferred compensation plans (as defined under section 409A), including plans of both private and publicly-held corporations.

As under section 409A generally, this limitation is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The regulatory authority of the Secretary of the Treasury to prescribe regulations as are necessary to carry out the purposes of section 409A generally applies to the provision. Under such existing regulatory authority, it is expected that the Secretary of the Treasury will issue guidance relating to defined benefit arrangements, including the application of the annual limitation and determination of the amounts deferred.

Effective Date

The provision applies to taxable years beginning after December 31, 2006, with respect to amounts deferred after such date (and earnings on such amounts). Amounts deferred (and earnings on amounts deferred) in taxable years beginning before January 1, 2007, are not subject to the provision. Taxable years beginning on or before December 31, 2006, are taken into account in determining the average annual compensation of a participant during any base period.

The provision directs the Secretary of the Treasury, within 60 days after enactment, to issue guidance providing a limited time period during which a nonqualified deferred compensation plan adopted before December 31, 2006, may, without violating the requirements of section 409A, be amended to provide that a participant may, no later than December 31, 2007, cancel or modify an outstanding deferral election with regard to all or a portion of amounts deferred after December 31, 2006, to the extent necessary to meet the requirements of the provision. Amounts subject to the cancellation or modification are currently includible in income to the participant to the extent not subject to a substantial risk of forfeiture and not previously included in income. Such guidance must also allow nonqualified deferred compensation plans adopted before December 31, 2006, to be amended to conform to the requirements of the provision with regard to amounts deferred after December 31, 2006.