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## **Anticipated Senate Bill Will Tax AIG (and Other) Bonuses and Will Impose a \$1 Million Cap on Deferred Compensation**

A bill (S. 651) has now been introduced in the Senate as the counterpart to H.R. 1586. It seeks to tax the “excessive” bonuses paid to individuals by TARP recipients. In addition, the Senate bill would limit the deferred compensation of TARP recipients to no more than \$1 million per year.

### **Background**

S.651 was introduced by Senators Baucus, Grassley, Wyden, Snowe, Lincoln, Kerry, Schumer, Menendez, Nelson (Fla), Bingaman and Cantwell. As introduced, it would generally apply to excessive bonuses paid after December 31, 2008. The specific provisions limiting deferred compensation apply to taxable years beginning after December 31, 2008 with respect to amounts deferred after the date of the bill's enactment.

The burden on excessive bonuses would consist of a 35% excise tax imposed on the covered individual and separately on his employer (i.e., the TARP recipient). The term “covered individual” means a director, officer or other employee of such recipient. These excessive bonuses would remain subject to income tax so that in total a targeted bonus would be taxed to the employee at approximately 70% -- a combination of an assumed 35% normal income tax rate and the 35% excise tax rate, with an additional 35% excise tax on the employer.

The term “excessive bonus” means either a “retention bonus” or an “applicable bonus payment.” The targeted excessive bonus is the portion of the applicable bonus payment in excess of \$50,000 paid for services performed in that calendar year and the portion in excess of \$50,000 which is attributable to services performed by the individual during any preceding year.

The term “applicable bonus payment” includes any bonus payment by a federal emergency economic assistance recipient. In order to be a federal emergency economic assistance recipient the employer must have outstanding

net federal emergency economic assistance in excess of \$100 million.

The term “bonus payment” includes any amount that is in addition to payments for services that are compensated at a regular hourly, daily, weekly, monthly or similar periodic rate. The term does not include commissions, contributions to a qualified retirement plan, welfare and fringe benefits, overtime pay or expense reimbursements. Payments, other than retention bonuses, are not treated as bonus payments if they consist of an equity interest (granted on or after January 1, 2009) if no portion of the interest vests before the date which is three years after the date on which the interest is granted. The term “equity interest” includes both stock options and stock appreciation rights granted at fair market value as well as restricted stock.

The term “retention bonus” means any bonus which is contingent on the completion of a period of service with the employer, completion of a specific project or other activity or such other circumstances (other than separation from employment for cause) as the Revenue Service may prescribe and which is not based on the performance of the individual. A payment is not treated as based on performance solely because the amount of the payment is determined by reference to a previous bonus payment which was based on performance.

The bill also increases the wage withholding by an amount equal to 35% of any “excessive” bonus that is treated as wages. Special rules are provided for nonresident aliens. Like the House bill (H.R. 1586), this

legislation would allow individuals to avoid these taxes if the excessive bonus is repaid. Under this bill, the repayment must occur before the due date of the individual's tax return on which it would be reported. Employers subject to these rules also will have a duty to notify the IRS of each covered individual who has received an excess bonus.

In addition to the new taxes, the bill would modify Revenue Code section 409A to add new section 409A(a)(5) which would impose a \$1 million limitation on the annual amount of any deferred compensation. This provision would apply in the case of deferred compensation from any federal emergency economic assistance recipient that maintains a nonqualified deferred compensation plan. Only amounts deferred after December 31, 2008 would be subject to these limitations. Failure to comply with the limitations would subject all of the deferred compensation to taxes under section 409A, including the 20% additional tax, as well as the 1% additional rate interest on underpayment.

The \$1 million limit is indexed for inflation. Interest and earnings on compensation deferred would not be counted against the \$1 million limit so long as the earnings are based on a "market rate" of return. For this purpose, the legislation requires the Service to issue regulations addressing the calculation of a market rate of return and specifically states that the regulations should provide that earnings based on a predetermined investment can be considered a market rate of return, in appropriate cases, including stock or other ownership interests in the employer maintaining the plan (whether or not publicly traded).

This provision appears responsive to many concerns expressed by AALU and other organizations about legislation proposed in 2007 which would have extended far beyond TARP recipients and which would have had a broad negative impact on important retirement savings. The 2007 proposal would have limited annual deferrals to the "lesser of" \$1 million or the five-year average of taxable compensation. It also would have counted earnings on past deferrals against that limit and would not have indexed the limit for inflation. One concern stressed by AALU and other organizations does not appear to be reflected in S. 651—the need for some exception from the limit for non-elective deferrals.

The legislation requires the Service to issue guidance within 60 days after enactment to provide that before the end of 2009 a participant may terminate participation in the plan or cancel or modify an outstanding deferral election with regard to all or a portion of the amounts deferred after the date of enactment of the bill to the extent necessary to meet these new requirements.

From the foregoing and the action in the House of Representatives yesterday on H.R. 1586, it is apparent that the AIG bonuses have created sufficient outrage in Congress that legislation designed to recoup most or all of the bonuses in question is likely to be enacted. The approach in S.651, however, is quite different from the approach adopted by the House. If S.651 is adopted by the Senate in its current form, a conference committee will have to work out the differences before final enactment. Because the Senate bill is less confiscatory with respect to individuals (the maximum tax rate on the individual is 70% in the Senate bill versus 90% in the House bill), the Senate bill may be viewed by some as less subject to constitutional challenge for improperly taking property. Nevertheless, both bills are.

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