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November 26, 2008

W. Thomas Reeder
Benefits Tax Counsel
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Helen Morrison
Acting Deputy Benefits Tax Counsel
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Tom and Helen:

At different seminars over the last few weeks, the potential legislative expansion of Section 162(m) has surfaced. Helen has commented on the possibility of a revision that would have an executive who is treated as a "covered employee" after enactment of new legislation to always be treated as such and, accordingly, compensation paid after employment termination would be subject to the deduction limitation.

To the extent that Treasury considers possible changes to Section 162(m), one important component of the analysis is its effective date of any changes – in particular, whether compensation for services rendered in years prior to enactment of any change but paid after enactment should be subject to the expanded limitation.

During 2007, the Senate Finance Committee approved a bill that would have expanded the Section 162(m) definition of "covered employee" in the manner described above. As written, the 2007 bill language would have applied to all compensation related to services before its enactment that is distributed and otherwise deductible in a latter year. For example, assume a "covered employee" deferred $1 million annually from base salary starting in 2000 for an aggregate $9 million through 2008. Assume also that the deferred compensation is payable in a lump sum in the year immediately following employment termination, which we can assume is 2015 for purposes of this example. If Section 162(m) is revised to apply to all compensation deductible starting in 2009, then $8 million of the $9 million paid in 2015 and relating to the pre-2009 deferrals would not be deductible. As a point of clarification, this example ignores earnings on the deferred amounts (or more appropriately negative earnings in today's market) during the deferral period.

If the law were changed to apply to pre-existing deferred amounts, a key financial accounting issue that surfaces is the potential immediate earnings impact. In the example above, the earnings charge taken each year by the corporation for financial reporting purposes during years

Francesco.Ferrante@ThompsonHine.com Phone 937.443.6740 Fax 937.443.6637

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THOMPSON HINE LLP
ATTORNEYS AT LAW

2000 Courthouse Plaza, N.E.
P.O. Box 8801
Dayton, Ohio 45401-8801

www.ThompsonHine.com
Phone 937.443.6600
Fax 937.443.6635

2000 through 2008 would be approximately $600,000, calculated as the $1 million compensation deferral less the expected tax benefit using an assumed 40% tax rate under the law in effect during such period. If legislation is enacted in 2009, it would seem that an immediate $3.2 million financial earnings charge must be taken by the employer in that year, calculated as the aggregate tax benefit that had been taken into account during the 2000-2008 period ($400,000 x 8) that would no longer be deductible. The reason for the immediate earnings charge would be because if the law is changed to continue to treat the executive as a "covered employee" after employment termination, then the expected tax benefit that had previously been taken into account to reduce the earnings charge would no longer be available in this example. Accordingly, the $400,000 annual tax benefit (40% of 1 million) that was taken into account in calculating the financial earnings charge for each year would be unavailable.

I understand that a more detailed accounting analysis is warranted to take into account different variables (such as the 2008 accounting effect for any reduction in the account balance stemming from negative earnings). The example and the potential accounting effect that could occur across corporate America has been simplified to surface the consequence. The financial accounting consequence is compounded when the effect of the earnings charge stemming from all nonqualified supplemental retirement arrangements are taken into account.

Due to the accounting treatment and for other reasons, consideration should be given to having any future legislative Section 162(m) proposal impact only compensation relating to services rendered in the year of enactment and thereafter. Under this approach, there would be no accounting earnings charge in 2009 for pre-existing deferrals and the lump sum payment of deferred compensation in 2015 after employment termination would be deductible as under existing law.

If a change in the law impacts pre-existing deferrals, the corporation is penalized after the fact. If the corporation could have anticipated a change in law, it could have prevented the initial deferrals and taken into account a full deduction for both tax and financial reporting purposes in the prior years. To change the rules midstream, denying the corporation's deduction and causing an accounting charge would cause a result that could have been avoided by an earlier payout.

The suggested effective date for any future Section 162(m) proposal to expand the "covered employee" definition — that is, to have the legislation effective only for compensation earned on and after enactment — is consistent with the approach that was adopted in the recent financial institution bailout legislation. The Emergency Economic Stabilization Act of 2008 ("EESA") expanded Section 162(m)(5) to apply to compensation for services rendered by a "covered executive" at a financial institution under certain circumstances. Deferred compensation earned and attributable to years that precede government assistance to the financial institution is not

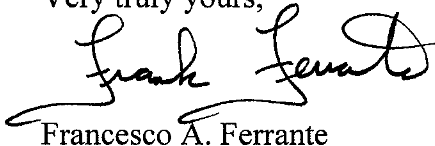
subject to the newly revised Section 162(m) provisions, including the expanded definition of "covered executive."

If the definition of "covered employee" is expanded, an additional point that would need to be considered is the application of the expanded definition to nonqualified supplemental retirement arrangements that are intended to provide benefits in excess of the qualified plan limitations. Some of these arrangements provide for benefits to vest as of a certain age or following a period of service. For example, under certain supplemental retirement arrangements, a legally binding right arises when the executive is designated as a participant and the executive works annually towards a fixed vesting date with compensation from years prior to vesting taken into account to calculate the benefit payable. If any future legislative change is not applicable to pre-existing deferrals, an issue for consideration is whether some portion of the benefit in this example can be considered earned prior to 2009 and not subject to the limitation. It seems that consideration has been given to this type of issue under IRS Notice 2008-94 Q/A#9 addressing the application of the Section 162(m)(5) revision made by EESA. The approach used in the IRS Notice is that a portion of the compensation would be deemed attributable to the period prior to the vesting date. To the extent that the compensation is attributable to years that precede the effective date of any change to Section 162(m), then such amount would not be subject to the limitation.

It could be that the effective date issue surfaced in connection with drafting the most recent Section 162(m) legislative revisions under the bailout provisions. However, if not, I hope that this point is taken into account.

Thank you for your attention.

Very truly yours,



Francesco A. Ferrante