GOP Tax Reform Plan Eliminates §162(m) Performance Pay Exception, Makes Major Changes to Deferred Compensation

In an Attempt at Repealing 409A and Eliminating Nonqualified Deferred Compensation, Draft Tax Bill Language Would Tax Options, SARs at Vesting

After several high-profile legislative failures, the Trump Administration has set its sights on tax reform as its next legislative objective. On November 3, 2017, House Republicans revealed the draft tax reform bill which will serve as a legislative starting point for the House Way and Means Committee. Almost immediately, Democrats criticized the proposal and its ultimate fate is still very much uncertain. Yet, there exists a general consensus that the tax code is in need of a comprehensive overhaul. Thus, early Democratic opposition could indicate the party's opening foray into negotiations as contrasted with past attempts to stop all legislation from moving in effort to deny President Trump any victory. As for executive compensation tax policy, there are two main provisions that the draft tax bill changes on:

- The Repeal of 409A Yields New Tax Treatment of Equity Compensation. Section 409A, known for its absurd complexity, which is and disliked due to its association with the Enron corporate scandal, is repealed in the GOP's tax bill, which will have significant impacts for companies that use benefits restoration plans for a wide range of employees. In repealing Section 409A, the bill provides for new Section 409B, which states that equity compensation will be taxed at vesting – not exercise. If the provision is not adjusted, it is likely to have a significant impact on the use of stock options and stock appreciation rights for companies.
- The Performance-Based Pay Exception to Section 162(m) is Repealed. Historically, 162(m)'s performance pay exception for proxy officers has been roundly criticized by members of both sides of the aisle. It is no surprise, therefore, that the draft tax bill repeals the provision, along with the exception for commission based pay. As a result, companies can no longer deduct employee compensation for their CEO and other select top executives which exceeds $1M. From a political perspective, Republicans are acutely aware of how the Democrats will attempt to frame any reduction in the corporate tax rate. Limiting tax benefits on executive compensation is a populist issue that offers the GOP a significant bargaining chip which they can use to sell the lower rate to Democrats and some populist Republicans.

The following policy brief summarized the executive compensation changes in tax reform, as well as how executive compensation is being viewed in the larger context of tax reform.

For Many Corporations, Benefits of a Marginal Tax Rate Decrease Is Offset by Increases. To put the tax reform debate into context, the U.S. has the world's highest marginal tax rate at 35% and an effective tax rate that is on average 7.6% higher than other large countries. The GOP's draft tax bill would lower the corporate rate to 20%. However, offsetting tax increases threaten to blunt the positive effects of the drop in the marginal rate.

Populist Rhetoric, Long-Existing Campaigns to Ensure Executive Pay Is in Crosshairs for Tax Reform Effort For several years, income inequality has been a headline topic when discussing economic issues. Part and parcel to the discussion of income inequality has been a debate over executive compensation. Democrats have long tied the two topics together, targeting compensation approaches used by companies as well as tax policy which is also blamed for the rise in compensation levels. The populist rhetoric which spurred stunning election results across the globe and has resulted in surprising reform attempts in the UK has accentuated the focus on inequality.

Two executive compensation tax policies are routinely targeted in discussions about income inequality – Section 162(m) and Section 409A of the Tax Code. A widely circulated article by former Secretary of Labor Robert Reich provides an excellent example of the typical criticisms of Section 162(m) (see below for a description of Section 162(m)). In the article, Mr. Reich criticized section 162(m) as creating a "pay for performance loophole" allowing executives to be awarded "performance awards based on nothing more than an upward drift in stock price." Other progressive advocacy groups have argued that section 162(m) amounts "to a structural change in how executives are paid," and that all performance-based exceptions should be eliminated. Likewise, the Institute for Policy Studies issued a report which characterized 162(m) as allowing CEOs to "rak[e] in huge taxpayer-funded bonuses at the same time they are insisting on deep cuts in the government programs that benefit ordinary Americans."

The campaign against Section 162(m) has yielded multiple bills in Congress by Congressional Democrats over the last several years. In multiple sessions of Congress, Senators Jack Reed (D-RI) and Richard Blumenthal (D-CT) have introduced the "Stop Subsidizing Multimillion Dollar Corporate Bonuses Act" which sought to eliminate the performance-based pay exception to 162(m) and implement a flat $1 million limit on compensation deductions for all current and former employees, regardless of whether they are executives. The bill also would have applied the $1 million limitation to former employees, and thus would eliminate the ability of companies to deduct payouts of nonqualified deferred compensation in excess of $1 million.

More recently, Democrats have shifted the rhetoric away from a focus on capping 162(m) deductions. In a move aimed at aligning the tax code focus with the party's income inequality mantra, the Democratic Party's "Middle Class Jumpstart" campaign for the fall 2014 election cycle sought to condition the ability of a company to receive deductions under 162(m) on the company's raising the minimum wage for their employees. The legislation, the "CEO/Employee Pay Fairness Act" by Rep. Chris van Hollen (D-MD) was introduced in the House in late October 2014 and would have created additional limitations on employers deducting compensation for executive officers under Section 162(m) of the tax code. Specifically, the bill would have prohibited companies from deducting compensation for executive officers, directors *and* employees in excess of $1 million, even if it is performance-based, unless companies provide raises for non-highly compensated employees on an annual basis and within certain parameters.

As for Section 409A, the provision is infamous for its complexity, which has included an excessively lengthy rulemaking process. Further, given that the creation of Section 409A was driven by the corporate scandals of the early 2000s, most notably Enron, the provision was linked to perceived "special benefits for executives" from the start. It will be an easy target going forward.

Reform Bill to Eliminate Nonqualified Deferred Compensation, Throws Tax Treatment of Equity into Question

Another known target for the 2017 tax reform effort is the repeal of Section 409A of the Internal Revenue Code, which provides for nonqualified deferred compensation and requires certain approaches to deferred payments be followed or the deferrals will trigger current taxation and a 20 percent excise tax to the executive as well as penalties and interest. The primary requirements of 409A are that an employee must elect to defer the compensation in the year before the compensation is received (*i.e.,* there must be a "substantial risk of forfeiture") and distributions can only be made under six special circumstances. Nonqualified deferred compensation and 409A compliance is notoriously complex. Section 409A became law following the Enron scandal in which executives withdrew nonqualified deferred compensation as the company collapsed. Since that time, 409A has been a favorite target of Democratic lawmakers, in part because repealing it has been estimated to raise $12.1 billion over 10 years.

Given the politics and more importantly, the revenue implications, it is no surprise that the GOP's tax bill repeals the provision outright. However, in doing so, the tax bill provides for new section 409B which sets new rules to the deferral of compensation that appears to eliminate most forms of nonqualified deferred compensation, including retirement benefits restoration plans, which is likely to have far ranging implications for some employers. The bill provides for the immediate taxation of compensation, including equity, upon *vesting* – not

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exercise – absent "significant risk of forfeiture". Significant risk of forfeiture is defined as the providing of future services. Non-compete agreements are expressly excluded from the definition of future services, meaning that most severance arrangements are immediately taxable, even if they are conditioned on covenants not to compete. The provision contains the following exception "[c]ompensation shall not be treated as deferred for purposes of this section if the service provider receives payment of such compensation not later than 2 1⁄2 months after the end of the taxable year of the service recipient during which the right to the payment of such compensation is no longer subject to a substantial risk of forfeiture." While this does provide an avenue for avoiding being required to treat performance-based pay awards as deferred that are paid early in year following the year of service, the provision does not apply to stock options. Thus, if this provision were to become law as drafted, the use of stock options would be significantly curtailed.

As written, 409B creates an inconsistent and untenable taxation scenario for stock options and SARs which separates the concept of matching income and taxation, and thus would largely render options unusable as vehicles for alignment of compensation with shareholder interests. Here are three examples of how 409B creates tax inconsistencies:

- **Example #1 – "In the Money" Stock Options** – If stock options are taxed at vesting as proposed, the IRS would presumably value the income by using the intrinsic value of the option (the "strike price" multiplied by the number of shares vesting). Assume, for example, that an individual is granted 10 options with a 10-year term that all vest after three years at a strike price of $10, and after three years, the stock price has appreciated to $15 per share, the individual would presumably be taxed on income of $50 ($5 per share appreciation x 10 shares). However, because the individual has not exercised the options, there would be no actual income. Suppose further that the value of the stock goes up to $20 in year seven and the individual then exercises the options, realizing a net intrinsic value of $100. Having already paid tax on the $50 in presumed income at the vesting date, it is assumed that the executive is not required to pay taxes on the additional $50 in income realized in year 7.[1] (However, one potential reading of the language is that the language anticipates a "true up" in the year of exercise to recognize, and tax, any additional income. This will need to be clarified during the legislative process.)
- **Example #2 – "Underwater" Stock Options** – Alternatively, suppose the value of the stock declines to $5 a share at the end of year 9. The market value of the options is less than the exercise price and the options are without value (*i.e.*, "underwater") at expiration. The individual would have paid $50 in tax in year 3 on 10 shares of stock that he or she does not own.[2]
- **Example #3 – Stock Appreciation Rights** – For the purposes of taxation, function virtually identical and create the same set of inconsistencies due to the changes in new 409B. The only difference is that stock appreciation rights only give individuals the right to the value of appreciation between the market price and the strike price.
- **Example #4 – Restricted Stock Units** – A similar problem occurs when a company grants performance-based restricted stock units (RSUs) to individuals that provide for accelerated vesting when the individual hits retirement age. The value of the equity award is not determinable until the performance-period ends, and typically, the individuals continue working and are still subject to the terms of the plan. In such a scenario, upon reaching retirement age, the performance-based RSUs vest in full and thus, under new 409B, would be subject to immediate income taxation (although the amount of income to be recognized is unclear based on the provisions of the bill). However,

[1] This scenario provides a great example of why startups rely so heavily on options. Key individuals can be provided with options to purchase stock at a low price that will appreciate if the company is successful. The incentive to stay with the company because of the potential increase in the value of stock options is an extremely effective retention tool.
[2] It is worth noting that if a value of a company's stock falls below the strike price the options are – "under water" – and no one would exercise them as to do so would essentially be deliberately losing money.

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although the individual's shares have vested, they are otherwise still subject to the terms of the RSU plan and will not gain actual receipt of the shares until the performance period ends. When that occurs, the individual receives full ownership of a set number of shares based upon the level of performance. Under Section 409B as drafted:

- If the performance level at the end of the performance period is below the value calculated at the vesting date, the individual will have paid more in taxes than the income realized from the award;
- If the performance level at the end of the performance period is higher than the calculated value at the vesting date, the individual receives a net tax benefit, resulting in less tax paid to the Treasury than income received.

Due to Revenue Raising Benefits, Tax Proposal to Eliminate Performance-Based Pay Exception to Section 162(m) Having demonstrated over the years that executive compensation is a target of Republicans as well as Democrats, there is little surprise that the GOP's bill eliminates the performance-based pay exception to Section 162(m). Section 162(m) has long been criticized by Republicans as well as Democrats with former SEC Chair Christopher Cox stating that it belonged "in the museum of unintended consequences" for having served to make $1 million a *de facto* compensation floor for CEOs. As drafted, the GOP's tax bill would:

- Eliminates the Exceptions for Performance-based and Commission-based Compensation. As section 162(m) is currently written, compensation paid to executives in excess of the $1 million cap can be deducted if it is performance or commission-based. Performance-based compensation includes stock options, which are considered to be *per se* performance based, as well as plans including performance goals approved at least every five years by an independent compensation committee and by shareholders and where performance under the plan is approved annually by the committee. The GOP's tax bill repeals this exception to section 162(m), imposing a hard cap for covered employee compensation deductions at $1 million, with no exceptions.
- Expands Application of 162(m) to CFO, Top Three Paid Officers: The GOP bill would also expand the coverage of Section 162(m) to a company's CFO – a role previously excluded – and three top paid officers. In essences, this brings the provision in line with the executives whose compensation is disclosed in the Summary Compensation Table. The change falls far short of some calls by Democrats to expand 162(m) to the entire company.
- Applies to Former Employees or to Beneficiaries. The bill also will expand the $1 million limit under 162(m) to former employees, and to payments made to someone else, such as the employee's beneficiary in the event of death.
- Applies to Companies Required to File 10-K, but Not Proxy, Including Public Debt Issuers. Currently, public debt issuers only need to file an annual report. The bill would subject them to the $1 million deductibility limit for the CEO, CFO and three most other highly compensated employees.

The most obvious likely impact of reform would be that 162(m) will apply to all named executive officers and that companies will be prohibited from deducting at least performance-based compensation for those executive officers, and the increased expense is likely to negatively impact company net income and correspondingly shareholder returns.

Conclusion With the draft bill of tax reform unveiled, the next phase will focus on the changes to the bill which will be made in the House Ways and Means Committee. The discussion in Committee will provide an opportunity to bring up concerns with the proposal, particularly with the impact on the use of stock options and equity resulting from the changes to Section 409A and the introduction of new 409B.

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