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Dramatic Changes to Code Sections 409A and 162(m) Proposed by Republican Ways and Means Chairman

House Committee on Ways and Means Chairman Dave Camp (R-Mich.) has put forth a draft bill (the "Tax Reform Act of 2014") that provides for significant changes to the Internal Revenue Code ('Code"). The bill is intended to simplify the Code and provide for lower tax rates for individual and businesses. In order to support the changes in the tax rate structure, many credits, deductions and other tax provisions are proposed to be reduced or eliminated. Executive compensation programs are among those on the chopping block, as described below.

Essentially No Deferral of Compensation Earned After 2014

The bill provides that nonqualified deferred compensation attributable to services after 2014 will be subject to taxation when there is no longer a "substantial risk of forfeiture," i.e., when amounts vest. This would largely eliminate the opportunity for executives to defer income taxation on compensation earned.

- For these purposes, a "substantial risk of forfeiture" exists only if the individual's right to such compensation is conditioned upon the future performance of substantial services.
- Compensation under a qualified employer plan, bona fide leave plan, disability, or death benefit plan would be exempt from these rules.
- Deferred compensation includes "compensation based on the appreciation in value of a specified number of equity units . . . or stock options."

The bill provides for its own version of a short-term deferral rule – compensation that is paid no later than 6 months after the end of the employer's tax year in which the compensation is no longer subject to a substantial risk of forfeiture will not be considered deferred compensation.

This provision, incorporated into the Code as a new Section 409B, would appear to make it very difficult to provide employees with excess retirement benefits. These new rules could also cause companies to review common compensation arrangements including severance programs that make payments extending beyond the new "short-term deferral rule" and a variety of cash and equity incentive awards.

Taxation of Existing Deferred Compensation Amounts by 2022

Just as the bill creates a new deferred compensation rule, it eliminates the nearly 10-year old Code Section 409A with respect to amounts attributable to services performed after 2014. For deferred compensation related to services performed before 2015, Code Section

409A will continue to apply, at least for a little while longer. To the extent such deferrals are not included in income before 2023, the deferrals will be includible in income generally as of the later of (a) 2022, or (b) the year there is no substantial risk of forfeiture (as described above).

The bill requires the IRS to issue guidance allowing arrangements subject to Code Section 409A to be amended to conform the distribution of deferred compensation to the dates that the amounts are required to be included in income. Thus, it should be permissible to pay these amounts out once they are subjected to taxation, leading to some large cash outflows for companies over a short time-frame.

If the bill passes, more complexities will arise and need to be addressed as the IRS focuses on implementing transition rules for amounts already subject to Code Section 409A and pre-409A grandfathered amounts.

Performance-Based Compensation Will Be Subject to $1 Million Deduction Limit

The bill eliminates the commissions and performance-based compensation exceptions to the $1 million annual deduction limit for publicly traded companies under Code Section 162(m). Further, the bill expands the coverage of Code Section 162(m) by (a) identifying the chief financial officer as a covered employee, (b) providing that if an individual was considered a covered employee after 2013, the deduction limits will continue to apply to all of their compensation in the future, and (c) providing that the deduction limit applies even if the income is paid to someone else (including a beneficiary on the officer's death). These changes are effective for tax years beginning after 2014. The bill does not include any grandfathering provisions. On its face, the bill would appear to apply to performance-based compensation that has previously been granted, but will not be paid until after 2014 (including options not exercised until after 2014).

While many companies have used their deferred compensation programs to help minimize the impact of the compensation deduction limits of Code Section 162(m), the proposed changes to Code Sections 409A and 162(m) in the bill could result in all of that planning being for naught. If an executive is a covered employee after 2013, and the bill becomes law, any payment of deferred compensation in excess of $1 million during a single year after 2014 appears to not be deductible.

While these changes are dramatic, they do not go as far as the changes in Code Section 162(m)(6) applicable to health insurers under the Affordable Care Act. Those rules apply to all employees (not just the top five) and limit the annual deduction to $500,000 per employee (not $1 million).

25% Tax on Compensation over $1 Million at Tax-Exempts

The bill also imposes on tax-exempt organizations a 25% tax for the following amounts provided to covered executives: (a) annual compensation (excluding amounts in (b)) over $1 million and (b) excessive severance payments. For this purpose:

- Compensation generally includes all amounts treated as wages subject to federal income tax withholding, whether paid by the tax-exempt entity or a related entity (as defined).
- Excess severance payments are generally severance payments that exceed an executive's average annual compensation ("base amount"), if the executive receives severance payments in excess of three times his base amount.

- Covered executives are the organization's five most highly compensated employees each year. And as with the new section 162(m) rule described above, once an executive is covered by the provision, the executive remains covered, even after employment ends.

According to the Ways and Means Committee summary, this provision will discourage payment of "excess compensation" and subject tax-exempt entities to a limitation similar to the Code Section 162(m) limitation that applies to publicly traded companies.

This provision is also effective for tax years beginning after 2014.

Outlook for Tax Reform Act of 2014 and Implications

Chairman Camp's proposal is important even if, as predicted, tax reform legislation is not enacted this year. The executive compensation provisions described above are estimated by the Joint Committee on Taxation to raise approximately $25.3 billion in revenue over 10 years. Thus, these executive compensation provisions (which will likely appeal to Congressional Democrats) could be picked up as revenue raisers for other legislation. Consequently, these provisions, or similar ones, are likely to continue to pop up in in various legislative proposals.