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Executive Compensation

View From Groom: House Tax Bill Would Radically Curtail Executive Compensation

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On November 2nd, House Republicans released the Tax Cuts and Jobs Act (the ''House Bill''), a comprehensive proposal to reform Federal tax law, including radical changes to executive compensation practices. If passed, the House Bill would (i) eliminate nonqualified deferred compensation plans and severely limit the use of stock options, (ii) reduce the amount of deductible compensation paid to certain senior executives, and (iii) impose an excise tax on excessive compensation paid to top employees at tax-exempt organizations. As described below, these executive compensation changes are so far-reaching that every employer should pay close attention to them and the impact they would have on their compensation arrangements if tax reform winds up passing in something like its present form.

I. Ending Nonqualified Deferred Compensation and Transforming Stock Options

The House Bill would repeal Section 409A of the Internal Revenue Code (''Code'') and replace it with a new Section 409B. Section 409B completely eliminates an executive's ability to defer taxation of future earnings beyond the year of vesting and requires all existing, vested nonqualified deferred compensation amounts to be included in income by no later than 2025.

■ No Future Nonqualified Deferred Compensation – Section 409B prohibits the deferral of income for services performed after 2017, including deferrals under a SERP, a tax-exempt employer's 457(b) or 457(f) plan. Instead, this section requires compensation and any related earnings to be taxed in the year the amount is no longer subject to a ''substantial risk of forfeiture'' (i.e., vested). In addition, Section 409B more narrowly defines ''substantial risk of forfeiture'' to exist only if the amount is conditioned on the performance of substantial future services, meaning non-competes and performance conditions would not generally defer taxation. Arrangements taxable under Code sections 83 or 402(b), and governmental 457(b) plans would be excepted, but application of the rule to state and local government 457(f) or 415(m) plans is presently unclear.

■ No Grandfathering of Pre-Existing Nonqualified Deferred Compensation – Importantly, Section 409B *does not* grandfather amounts deferred with respect to services performed before 2018. Instead, Section 409B requires all existing nonqualified deferred compensation amounts solely attributable to services performed before 2018 to be taxed by no later than 2025, or if later, the year they vest. The House Bill requires the IRS to establish rules allowing employers to amend their plans to allow the date of distribution of amounts solely attributable to services performed before 2018 to conform to the date the amounts are required to be included in income without violating Section 409A.

■ Stock Options and SARs Taxable at Vesting – Section 409B dramatically expands the definition of ''nonqualified deferred compensation'' to specifically include stock options and stock appreciation rights (''SARs'') of publicly traded companies (i.e., awards taxable when vested). Currently, fair market value stock options and SARs are designed to be exempt from Section 409A and are not taxable to the holder until the awards are exercised. An amendment to the House Bill adopted by the Ways and Means Committee on November 6 would allow certain broad-based, ''qualified equity grants'' of private companies to be exempt from Section 409B. Under the amendment, rank-and-file employees at companies where no stock is readily tradable on an established securities market could defer income tax inclusion for up to 5 years on amounts attributable to certain stock options or restricted stock units.

Considerations and Concerns

If it were to become law, new Section 409B will undoubtedly have a major impact on the compensation practices of a wide range of employers from taxexempts to large public companies. Companies should start to consider the potential impacts of Section 409B, including:

- Companies will need to decide what to do with the open enrollment this year for 2018 deferrals. If Section 409B is adopted, no deferrals for services in 2018 may occur.

- Nonqualified deferred compensation paid to participants on an accelerated schedule under Section 409B (e.g., no later than 2025) may result in amounts being taxable at relatively higher federal marginal rates and subject to additional state and local taxes due to the loss of the state source tax blocker that could apply for payments over at least 10 years. These additional state and local taxes may in turn be rendered nondeductible against federal taxable income due to newly applicable state and local tax deduction limitations, resulting in accelerated taxation at significantly higher overall tax rates.

- The unanticipated liquidation of all pre-existing nonqualified deferred compensation amounts under traditional deferred compensation plans and SERPs may cause cash-flow and other financial statement impacts.

- Equity and incentive awards will need to be reviewed.
  - Section 409B changes the tax timing for most stock options and SARs and does not address how a company should calculate the taxable amount on the vesting date.
  - Long-term incentive programs (''LTIPs''), restricted stock units (''RSUs'') and performance stock units (''PSUs'') may no longer include any retirement vesting features.
  - Performance conditions on LTIPs, RSUs or PSUs are no longer sufficient to delay taxation. Incentive plans may need to add a requirement that participants must be employed on the payment date.

- Severance arrangements that pay over a period of time may need to be reviewed to avoid immediate taxation of the entire benefit. This may also complicate reimbursement provisions as well.

- Once again, employers will need to revisit and amend nearly all of their executive compensation arrangements, from LTIPs and bonus programs to equity plans and even employment agreements.

II. Eliminating Deductibility of Compensation Over $1 Million

For tax years beginning after 2017, the House Bill revises section 162(m) of the Code and dramatically expands the definition of compensation subject to the $1 million deduction limit for public companies by eliminating the performance-based compensation and commission exceptions. The House Bill also realigns who is covered by this limit with the SEC disclosure rules by including the company's principal financial officer along with the principal executive officer and other three most highly paid executives. In addition, if an individual is a covered employee for any tax year commencing after 2016, his or her compensation remains subject to the deduction limit in subsequent tax years, even if he or she is no longer a covered employee or the amounts are paid to a beneficiary. Similar to the new Section 409B rules, the changes to Code section 162(m) do not include a grandfather or a transition period.

Considerations and Concerns

Many publicly traded employers have carefully designed their compensation programs to take advantage of the performance-based compensation exception for amounts paid to top executives. Some major areas of concern include:

- Eliminating the performance-based compensation exception would cause companies to lose a tax deduction to the extent a covered employee's performance-based pay, stock options, and SARs when combined with other compensation exceed the limit.

- Because there is no grandfathering or transition period, a significant portion of the pre-existing nonqualified deferred compensation amounts to be paid in-service to, or after termination of, a covered employee pursuant to Section 409B would no longer be deductible, as originally designed.

III. New Excise Taxes on Executive Compensation at Tax-Exempt Employers

The House Bill's impact is not limited to compensation at for-profit employers. In order to address concerns over excessive pay practices at tax-exempt employers, the House Bill would impose a 20% excise tax on compensation in excess of $1 million paid to any of the top five most highly compensated employees, as well as payments contingent on separation from employment paid to those top five employees in excess of three times his or her prior average annual compensation. Similar to the new Section 162(m) rules described above, if an individual is a top five employee for any tax year commencing after 2016, the 20% excise tax rules continue to apply in subsequent tax years, even if he or she is no longer in the top group. These changes would be immediately effective for tax years beginning after 2017 without a grandfather or transition period.

Considerations and Concerns

The House Bill creates significant challenges for large tax-exempt organizations that need to attract and retain talented leadership, including:

- Without a grandfather or transition period, many large tax-exempt organizations may need to amend current employment agreements or compensation arrangements to account for the additional excise tax.

- Tax-exempt organizations may lose key tools (i.e., ''golden handcuff arrangements'') to retain executive directors and other senior leadership.

IV. What Employers Must Do Now

President Trump and Republican Congressional leaders are on a fast track to try to pass tax reform legislation by the end of the year. The Ways and Means Committee is currently marking up the House Bill, and House leaders plan for the House to pass the House Bill next week before the Thanksgiving recess. Senate Republican leaders have indicated that a draft Senate tax reform bill could be released later this week with a Senate mark-up to begin as early as next week. It appears likely that the Senate bill will contain executive compensation proposals similar (if not identical) to those in the House Bill.

If tax reform legislation is signed into law with the executive compensation provisions in their current form, employers of all kinds would have very little time to undertake a major overhaul of their executive compensation programs. Put simply, the legislation would be a ''game changer'' that would radically transform expectations regarding the taxation of past, present and future executive compensation arrangements. Moreover, there currently appears to be little opposition to these provisions on Capitol Hill. For any changes to be considered to make this legislation more reasonable, we believe that companies or their advocates will need to begin advocating for such changes on the Hill in the near future.

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We will continue to monitor legislative developments related to these issues and provide updates as tax reform legislation moves through Congress. Please let us know if you have questions about the impact of these proposals on your company's or organization's compensation arrangements or want to speak about possible advocacy approaches.