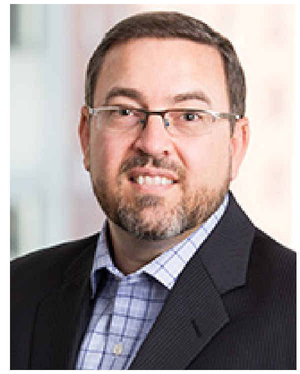
Executive Compensation Programs Are Still on the Chopping Block in Senate Version of "Tax Cuts and Jobs Act"



J. MARC FOSSE

Shortly after the House version[1] of the Tax Cuts and Jobs Act (the "Act") was amended to delete all provisions relating to sweeping changes to executive compensation programs, the initial Senate proposal for the Act was released, putting these provisions right back on the table. Although the Act is not law yet, because of the drastic nature of the proposed changes and the proposed January 1, 2018, effective date, we want to keep our clients informed of the executive compensation programs that may be eliminated for the 2018 taxable year. These proposed changes are particularly troubling as employers ramp up for open enrollment for their nonqualified deferred compensation plans with the potential that participant elections will not be valid for 2018. As discussed below, the Act's provisions could also make grants of nonstatutory stock options taxable before exercise.

Death Knell for Nonqualified Compensation Deferral Programs

The current Senate markup of the Act strikes section 409A of the Internal Revenue Code (the "Code") effective for any compensation earned after December 31, 2017, and replaces it with Code section 409B. Code section 409B provides that nonqualified deferred compensation must be included in income when it is no longer subject to a substantial risk of forfeiture. Nonqualified deferred compensation includes actual or notational earnings on amounts that accrue during the period the compensation is subject to a substantial risk of forfeiture. This new Code provision would, for all practical purposes, be the end of nonqualified elective deferral programs. The IRS has repeatedly stated that it does not believe that a rational taxpayer would subject his or her compensation to a substantial risk of forfeiture except for the sole purpose of avoiding taxes. For this reason, if the current Senate markup of the Act is adopted, then beginning in 2018 employees (and directors) will no longer have the ability to simply elect to defer payment of compensation to a later taxable year.[2]

"Substantial risk of forfeiture" is also more narrowly defined under the Act to mean only a period when the employee is required to provide substantial future services. Performance-based "vesting" will no longer be deemed to be a substantial risk of forfeiture. This means that the value of performance-based compensation would be included in taxable income when the employee first receives the legally binding right to the compensation, even if the amount of the compensation is contingent on future completion of individual or corporate performance goals. In order to defer taxation, the performance-based compensation would be required to have a concurrent service-based vesting period. In addition, "substantial future services" does not include a post-termination non-compete period.

Code section 409B excludes from the definition of nonqualified deferred compensation death, disability, sick leave, compensatory time and vacation leave programs. Unfortunately, the Senate proposal specifically prohibits the IRS from creating an exception from these rules for any type of severance pay plan, which means employers would no longer be able to provide for multiyear severance pay or benefits.

The changes described above would affect a wide range of popular employee benefit plans, such as nonqualified deferred compensation plans, supplemental executive retirement plans (SERPs), restricted stock unit programs (RSUs), phantom stock or unit plans, stock appreciation right plans (SARs), severance plans, change in control agreements, employee retention plans, and long-term incentive plans (LTIPs). However, the Senate proposal states that it would not apply to section 83 property or amounts contributed to a Code section 402(b) nonqualified employee trust. The traditional definition of substantial risk of forfeiture under Code section 83 (including performance-based vesting) will still apply to property transferred in exchange for services or benefits provided through a Code section 402(b) nonqualified trust.

Current Nonqualified Deferred Compensation Benefits Would Have to Be Distributed No Later than the 2026 Tax Year

Current nonqualified deferred compensation plans would need to be amended under the Act to provide that any amounts deferred based on compensation earned on or before December 31, 2017, must be included in current or former employees' income by the later of:

(i) the last taxable year beginning before 2027 (i.e., 2026), or

(ii) the taxable year in which the compensation is no longer subject to a substantial risk of forfeiture (i.e., vests).

It appears this distribution deadline would apply to all the plans currently excluded from application of Code section 409A (i.e., "grandfathered plans"). For example, a grandfathered plan that continues to link the time and form of payment to the time and form of benefits paid under the employer's tax-qualified plan would need to be amended to delink the plans and distribute all benefits by no later than the 2026 taxable year.

The IRS is instructed under the Act to issue regulations as necessary to carry out the purposes of this change in the law. Hopefully, if the current Senate version of the Act becomes law, the IRS will provide a transition period similar to what it did when Code section 409A was enacted, during which participants could redo their elections relating to time and form of distribution. This seems reasonable because all benefits would still be taxable no later than the 2026 tax year. Congress appears to have set this deadline because it wants the additional tax revenue collected in the current 10-year budgeting cycle so those revenues would apply against the current proposed tax cuts.

The Fair Value of Nonqualified Stock Options Would Be Taxed at Vesting

The current Senate markup of the Act also states that nonqualified stock options are included in the definition of nonqualified deferred compensation. This means that the fair value of nonqualified stock options would be included in an employee's income when the stock options vest (i.e., no longer subject to a substantial risk of forfeiture), regardless of whether the stock option is exercised at that time. Whether or not the exercise price is equal to the fair market value of the underlying stock on the date of exercise would not affect the treatment of a nonqualified stock option under the Act. The Act does not provide guidance on the value to be used to measure taxable income at the time of exercise or on whether any subsequent increase in value would continue to be taxed annually as ordinary income during the remainder of the exercise period. While some executives may be able to withstand this type of taxation prior to exercise, nonqualified stock options will no longer be a viable compensation method for rank-and-file employees.

Incentive Stock Options and ESPPs Not Affected

Incentive stock options under Code section 421 and options to purchase shares under a Code section 423 tax-qualified employee stock purchase plan (ESPP) are expressly excluded from the Act's definition of nonqualified deferred compensation. However, these programs are very limited in the number of options that can be granted to employees. The number of incentive stock options that would first become exercisable in any one year cannot exceed $100,000. Also, the value of shares purchased in a taxable year under an ESPP generally may not exceed $25,000.

Performance-Based and Commission-Based Compensation Would No Longer Be Excluded from $1,000,000 Deduction Limit under Code Section 162(m)

The Act would eliminate the performance-based and commission-based exceptions from the $1,000,000 limit under Code section 162(m) on the amount a public company can deduct for pay to its "covered employees." The definition of "covered employees" would also be revised to include the company's CEO, CFO and additional top three highest paid officers. An employee would be treated as a "covered employee" if the employee held any of those positions at any time during the year. Also, once an employee is a covered employee, the employee would remain a covered employee for all remaining years with respect to compensation paid by that employer and all companies within the employer's controlled group of companies, even after termination of employment or death. Under current interpretation of Code section 162(m), amounts that would be payable when the employee was no longer a covered employee or upon death of the covered employee could be excluded as 162(m) covered compensation. These benefits will now be included, unless the benefit is paid under a tax qualified plan or would otherwise be excluded from the covered employee's income under another section of the Code.

This change could affect not only the deductibility of pay to covered employees, but also require amendments to executive programs and compensation committee charters that contain affirmative prescriptions to take action so that covered compensation is deductible under Code section 162(m). If the Act becomes law, employers would need to determine whether these types of amendments require shareholder ratification of the changes and additional filings with the Securities and Exchange Commission.

We will continue to monitor developments regarding the Act and advise you of any important updates that may impact executive compensation programs.

---

[1] The November 9, 2017, markup of the Act by the Chairman of the House Ways and Means Committee deleted all provisions in the Act related to changes to deferred compensation programs for both non-profit and for-profit entities. However, the evening of November 9, 2017, the Senate issued its initial markups of the Act, which again included very similar revisions to the Code relating to executive compensation. This alert describes the provisions that currently could be included in the Act related to executive compensation.

[2] Under the Code sections 409A and 457 regulations, an employee can defer salary if the employee is provided a "material" benefit from the employer as an incentive to subject the compensation to a substantial risk of forfeiture. The IRS also permitted, under the proposed 457(f) regulations, "rolling vesting" based on similar requirements. If Code sections 409A and 457(f) are struck from the Code, we cannot be certain that the IRS will provide similar methods to defer employee compensation under the Code section 409B regulations.

NOVEMBER 2017

EMAIL MARC FOSSE