The Drama Continues: Senate Finance Committee Chairman's Mark includes Proposals That Would Dramatically Impact Executive Compensation Programs

Background

HR 1, the Tax Cuts and Jobs Act (House Bill), as introduced in the House Ways and Means Committee on November 2, 2017, included provisions that would, among other things, dramatically affect the taxation of employees and other service providers with respect to nonqualified deferred compensation (including stock options, stock units and stock appreciation rights) and would modify the rules of Section 162(m) of the Internal Revenue Code (Code) governing corporate deductions for compensation paid to certain executive officers. On November 6 and 9, Chairman Brady of the Ways and Means Committee proposed two amendments to the House Bill, later adopted by the committee, that (i) removed the draconian provisions that would have modified the taxation of nonqualified deferred compensation (while preserving the House Bill's proposed changes to Code Section 162(m)) and (ii) added certain enhancements relating to the taxation of stock options and restricted stock units granted to employees by certain private companies.

With the ink barely dry on Chairman Brady's amendments, the Joint Committee on Taxation released a 247-page description of the Chairman's Mark of the "Tax Cuts and Jobs Act," tax reform legislation proposed by Chairman Hatch of the Senate Finance Committee (referred to herein as the Senate Bill) that includes essentially the same harsh nonqualified deferred compensation taxation provisions that were eliminated from the House Bill, as amended.

As we go to press, an amendment to the Senate Bill introduced by Senator Portman on November 12, 2017, is pending that would eliminate the proposed changes to the taxation of nonqualified deferred compensation, but it is not clear if such amendment will be approved. In addition, Chairman Hatch of the Senate Finance Committee is scheduled to introduce a "Manager's Amendment" on November 14 that may also propose to delete the nonqualified deferred compensation provisions from the Senate Bill.

In addition, both the House and Senate Bills contain different miscellaneous provisions applicable to qualified and welfare plans.

The Bills are a long way from enactment, and even if enacted, they will undoubtedly be subject to numerous changes that may make the final law yet again different from each Bill's current terms Nonetheless, because many of the changes are proposed to go into effect as of January 1, 2018, it is important for employers to understand how the proposals may affect their benefit plans and compensation arrangements.

In this Legal Update, we outline (i) the principal provisions of the Senate Bill that would affect the taxation of nonqualified deferred compensation, (ii) provisions in both the House and Senate Bills that would modify the rules of Code Section 162(m) governing corporate deductions for compensation paid to certain executives and would impose excise taxes on certain compensation paid by tax-exempt entities, (iii) provisions in the House Bill applicable to certain equity awards granted by private companies, and (iv) miscellaneous proposed changes to the rules governing qualified plans and welfare plans.

Nonqualified Deferred Compensation

Repeal of Code Sections 409A and 457A and Enactment of Section 409B. Provisions repealing Section 409A and 457A and adding new Section 409B to the Code were initially included in, but later removed from, the House Bill. Provisions similar to those in the pre-amendment version of the House Bill are included in the Senate Bill, although in narrative form, rather than proposed statutory language, and without specific Code references.

Although Section 409A of the Code imposes arduous conditions on compliance and harsh consequences on violations, it does permit deferred taxation of compensation as long as the rules are satisfied. Further, since the enactment of Section 409A well over a decade ago, most of the rules are relatively well understood and can be implemented in a manner that provides some level of flexibility to service providers and employers with respect to their deferrals. Code Section 457A effectively precludes the ability to defer the taxation of compensation for employees and other service providers of "nonqualified entities" beyond the date such amounts are no longer subject to a substantial risk of forfeiture (which for Section 457A is narrowly defined to mean the continued performance of substantial services). Fortunately, nonqualified entities described in Section 457A are limited and do not include most US companies. In a drastic change for US employers and employees, the Senate Bill would effectively extend the requirements of Section 457A to deferred compensation arrangements of all service providers subject to US taxation. For ease of reference we refer to the new proposed Code provisions as "Section 409B."

Under Section 409B as proposed, deferred compensation of all employees and other service providers would be includible in income when such compensation is no longer subject to a substantial risk of forfeiture, which is defined to mean the continued performance of substantial services even if such compensation is not then distributable. This means that under the proposed changes, compensation would not be treated as subject to a substantial risk of forfeiture on account of a covenant not to compete, the satisfaction of performance conditions or the occurrence of any condition other than the performance of services.

A nonqualified deferred compensation plan would be broadly defined to include any program that provides for the deferral of compensation other than:

- A qualified employer plan, a bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plan;
- Transfers of property described in Code Section 83 (such as restricted stock); and
- Trusts subject to Code Section 402(b).

There is also an exception for short-term deferrals (generally amounts paid within two and a half months following the year in which the compensation vests) similar to the current exception provided in the regulations under Section 409A. The Senate Bill expressly provides that the Internal Revenue Service (IRS) may not provide an exception from the new rules for severance plans, bona fide or otherwise, in regulations or other guidance.

Stock Options and Stock Appreciation Rights (SARs). Section 409B as proposed would expressly include in the definition of "nonqualified deferred compensation" compensation attributable to nonstatutory stock options and SARs, even though stock options and SARs are generally exempt from Sections 409A and 457A, provided that certain conditions are satisfied. We do not yet know how these instruments would be taxed under the new regime, but it is possible that the taxation would follow the model that is applicable when the principles of Section 409A are violated. Under that approach, the stock options and SARs would be taxable upon vesting and the amount includible in income would equal the "spread"—that is, the excess of the fair market value of the stock either at vesting or a specified point during the year of vesting minus the exercise price and any amount paid for the option at grant (which is almost always zero). Absent exercise at the time of vesting, any increase in the value of the stock in subsequent years (including the year the option is exercised) would also be taxed. Whether this same approach would actually apply under Section 409B is as yet unknown. Fortunately, unlike Section 409A, which imposes a 20 percent penalty and premium interest on amounts that become taxable as a result of a violation of that Section, Section 409B does not provide for the imposition of a penalty or premium interest tax.

In contrast to the treatment of nonstatutory options, described above, the Senate Bill would expressly exclude statutory stock options (e.g., incentive stock options and options granted under employee stock purchase plans) from the definition of nonqualified deferred compensation under the new proposed rules.

Stock Units. Section 409B as proposed would also cover other rights to compensation based on the value or appreciation in value of equity units of the employer, whether cash or stock-settled. Consequently, restricted stock units would be taxable upon vesting even if settlement were deferred until a later date. In the case of performance stock units, taxation would apply upon the satisfaction of any time-based vesting requirement even if any applicable performance conditions were not yet satisfied. Also, because only the performance of substantial services would be recognized as a vesting condition, if an award provides for continued vesting on and after the date an employee retires (or full vesting if a person "retires"), the award would be vested for purposes of Section 409B, and the compensation attributable to the award would be taxable, when the service requirements are satisfied (e.g., upon eligibility for retirement even if there is no actual retirement).

Amounts Not Determinable at Time of Vesting. A feature of Section 457A that does not appear in Section 409B is the rule that if an amount of deferred compensation is not determinable at the time it becomes vested, taxation will be delayed until such amount is determinable, but the amount of income tax will be increased by 20 percent plus premium interest to the date such amount became vested. While the absence of such a provision is a welcome relief to the extent it means that a 20 percent penalty and premium interest would not apply, it leaves open the question of how amounts that are not determinable at the time that they become vested would be treated.

Effective Date/Application of Section 409B to Existing Deferred Compensation on Delayed Basis. A sure source of consternation is the lack of a true grandfather provision from Section 409B for amounts deferred prior to enactment. As in the case of Section 457A, pre-existing deferred compensation would be subject to the new rules of Section 409B, but on a delayed basis. Under proposed Section 409B, amounts attributable to services performed before 2018 would be taxed in the later of (i) the year in which such amounts become vested, or (ii) 2026. The IRS would be required to issue, within 120 days after the date of enactment, guidance providing a limited period of time during which nonqualified deferred compensation attributable to services performed on or before December 31, 2017 could be amended, without violating Section 409A, to conform the date of distribution to the date such amounts would be included in income under Section 409B. Further, such change would not be treated as a material modification under Section 409A with respect to amounts deferred prior to 2005.

For amounts that are not subject to the delayed implementation rule, Section 409B could apply as soon as 2018 and could require drastic changes in the design of companies' deferred compensation and incentive compensation programs starting immediately in 2018. Employers would also have to consider how to coordinate the new rules with the terms of the plans relating to distributions to minimize a mismatch between the taxation and the payment of amounts deferred under the plan prior to the effective date of the new rules. While it is too early and uncertain for companies to take actions based on the proposed Section 409B, it would be a good idea for companies to start to assemble a list of all plans, programs and contracts that could require amendment under proposed Section 409B if its changes become effective in 2018.

Executive Compensation

Repeal of Performance-Based Compensation Exception of Section 162(m). Both the House and Senate Bills contain provisions that would modify Code Section 162(m). We describe them below, noting differences between the Bills where relevant. Under Code Section 162(m), compensation in excess of $1 million paid to an individual who is a "covered employee" of a publicly traded company is not deductible.

The House Bill would expand the companies that are treated as public companies for this purpose, primarily picking up companies that have publicly traded debt (even if the stock of the company is not publicly traded). The Senate Bill would also expand the companies treated as public companies for Code 162(m) purposes although the exact scope of the expansion is not clear.

Under Section 162(m) as interpreted by IRS guidance, covered employees generally include the principal executive officer and the three most highly compensated employees of an entity, other than the principal financial officer, whose compensation must be reported to shareholders for the applicable year under the Securities Exchange Act of 1934. Exceptions to the $1 million limitation include, among other things, performance-based compensation that satisfies certain conditions and certain compensation payable as commissions. The exception for performance-based compensation is by far the most important exception and generally covers grants of stock options, which can generate enormous deductions for companies on exercise, as well as other incentive compensation granted by public companies such as performance-based cash bonuses, performance stock units and restricted stock grants subject to performance-based vesting.

Both Bills would repeal the exceptions for commissions and performance-based compensation, meaning that most employers would lose deductions for compensation in excess of $1million paid to their covered employees. The Bills would also expand the definition of covered employee by (i) including a company's principal financial officer in the definition, (ii) providing that an individual is a covered employee if he is the company's principal executive officer or principal financial officer as of any day in the taxable year (as opposed to the last day of the taxable year) and (iii) making the designation of any person as a covered employee for any year after 2016 permanent,including for years after the individual terminates employment or dies, rather than a making a year-by-year determination. These changes would apply for years after 2017.

Excise Tax on Compensation Paid by Tax-Exempt Organizations. Both the House Bill and the Senate Bill contain provisions that would impose an excise tax of 20 percent on (i) remuneration (other than an excess parachute payment) in excess of $1 million paid by certain tax-exempt organizations to a covered employee plus (ii) any excess "parachute" payment paid by such an organization to a covered employee. The employer would be liable for the tax. Covered employees are defined as the five highest-paid individuals of the organization (plus individuals who were covered employees in prior years beginning after 2016). Excess parachute payments refer to payments in excess of certain threshholds that are contingent on an employee's separation from service.

Equity Awards Issued by Private Companies. In a bit of good news, the House Bill, as amended, would add new Section 83(i) to the Code, which would permit certain employees who receive private company equity awards to defer income on these awards for up to five years beyond the date they would normally be taxable under Section 83 (i.e., the date the underlying shares are transferrable or, if earlier, are no longer subject to a "substantial risk of forfeiture.") There is no parallel provision in the Senate Bill.

Qualified Plans

There had been suggestions that the House Bill might include provisions that would lower the limits on contributions to 401(k) plans, but neither the original House Bill, nor the amended version, include such provisions. Rather, the House Bill's proposed changes with respect to qualified plans are largely liberalizations that would provide plan participants and employers with additional flexibility. Below we discuss the provisions in the House Bill relating to qualified plan changes.

Reduction in Minimum Age for Allowable In-Service Distributions. In general, a qualified defined benefit plan may not permit in-service distributions to a participant prior to the date that the participant attains normal retirement age. Current provisions of the Code, however, permit in-service distributions upon attainment of age 62 even if that is earlier than normal retirement age under the terms of the applicable plan. The House Bill would lower the age permitted for in-service distributions from age 62 to 59½, even if that is earlier than the normal retirement age under the plan.

In the case of Code Section 457 plans (deferred compensation plans which may be maintained by certain tax-exempt and government employers), in-service distributions prior to age 70½ currently are permitted in only limited circumstances (e.g., an unforeseeable emergency). The House Bill would reduce this age to 59½.

The foregoing changes would be effective for plan years beginning after 2017.

Modification of Hardship Withdrawal Rules. The House Bill includes three provisions intended to facilitate and expand the availability of hardship distributions.

Under current IRS regulations, a distribution from a 401(k) plan (also known as a qualified cash or deferred arrangement) will be deemed necessary to satisfy an immediate and heavy financial need (and will qualify as a hardship distribution), if among other things, the participant is precluded from making any contributions, whether pre-tax or after-tax, to the plan for six months after the withdrawal. The House Bill would require modifications to the regulations to delete the six-month prohibition on contributions.

The House Bill would expand the contribution sources available for hardship distribution from 401(k) plans. Currently, a 401(k) plan may make hardship distributions from employee before-tax contributions but not from employer contributions (e.g., qualified employer non-elective contributions or qualified matching contributions) or from earnings on such employee and employer contributions. The bill would permit the distribution of all of the foregoing amounts in the event of hardship.

The House Bill would also eliminate the current requirement that a participant take any available loan under the applicable plan prior to taking a hardship distribution.

All of the foregoing changes would be effective for plan years beginning after 2017.

Liberalization of Nondiscrimination Rules Applicable to Frozen Plans. Many employers have closed their defined benefit plans to new participants but permit existing participants to continue to accrue benefits. Due to different rates of attrition between highly compensated and non-highly compensated participants, these closed plans can often become discriminatory. The House Bill provides for liberalized testing rules for closed plans that meet certain requirements.

Extended Rollover Period for Plan Loan Offset Amounts. A loan offset amount is the portion of a participant's qualified plan account balance that is used to pay off a plan loan when the plan terminates or the participant terminates employment without paying the loan off in accordance with the terms of the plan. This amount is taxable unless the participant rolls over an amount equal to the loan offset amount to another qualified plan or individual retirement account within 60 days following the distribution. The House Bill would extend the 60-day rollover deadline to the due date (including extensions) of the employee's tax return for the year in which the distribution occurs.

Senate Bill. The Senate Bill includes provisions that would coordinate the limits on contributions to a Section 457 plan with those applicable to Section 401(k) and 403(b) plans. The Bill would harmonize the rules applicable to elective deferrals and catch-up contributions under Section 401(k), 403(b) and 457 plans and would also repeal the rule that allows employer contributions to a Section 403(b) plan for up to five years after termination of employment. The proposal would also impose a single aggregate limit on contributions for an employee to any defined contribution plans, Section 403(b) plans and Section 457 plans maintained by the same employer controlled group or affiliated service group. The Bill would extend the 10 percent additional income tax on withdrawals prior to age 59½ to distributions from a government Section 457 plan. Finally, the Bill would eliminate catch-up contributions for employees who received wages of $500,000 or more for the preceding year.

Welfare and Fringe Benefits

Welfare and fringe benefits would not fare as well under the House Bill as qualified plans. The types of exclusions from income that would be repealed by the Bill include income for for employee achievement awards, tuition reimbursements, qualified moving expense reimbursements and adoption assistance, generally effective for taxable years s beginning after 2017. In addition, the House Bill would repeal the income exclusion for dependent care programs, a common benefit under employer "cafeteria" plans, effective for taxable years beginning after 2022. The Senate Bill would repeal the exclusions for qualified moving expense reimbursements and qualified bicycle commuting expense reimbursements, effective for years beginning after 2017.

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