Executive Compensation and Benefits Alert

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Ways and Means Tax Reform Bill Proposes Fundamental Changes to Executive Compensation

House Ways and Means Committee Chairman David Camp (R-Mich.) has proposed a draft tax reform plan (the Proposal) containing sweeping changes to the Internal Revenue Code (the Code), including a number of major executive compensation and benefits changes, most significantly the elimination of deferred compensation and nonqualified pensions. While it is unlikely that the Proposal will become law this year or be adopted in its current form, it is already serving as a springboard for the tax reform debate and, as such, it is important to understand its provisions. In addition, the revenue-raising nature of many of the proposed compensation and benefits changes could be attractive to legislators, even if complete tax reform is not achieved.

Key changes include:

Deferred Compensation and Nonqualified Pensions Eliminated

- Under the Proposal, an individual would be taxed when compensation vests — that is, when the right to receive the compensation is no longer subject to the future performance of substantial services. While this proposed change certainly would simplify an area that has become increasingly complex, it would severely limit the ability of individuals to plan for retirement by deferring current income and eliminate the ability of companies to provide executives with supplemental retirement plans without current taxation. It also may impact the structure and payment format of severance arrangements. The elimination of the ability to defer compensation would make Sections 409A and 457A of the Code unnecessary and, accordingly, they are eliminated as part of the Proposal. The new rules would apply to compensation earned with respect to services performed January 1, 2015, and later, and previously earned amounts would be required to be paid (and therefore, taxed) no later than 2022 or, if later, the first taxable year in which the individual is no longer required to perform services to have a right to the amount.

Stock Options and Other Equity Awards

- The Proposal eliminating deferral of compensation also applies to stock options and any other right to compensation based on appreciation in share value. As a result, many equity awards (including stock appreciation rights and phantom units) automatically would be taxed on vesting. It is unclear how this would work in practice — for example, if a stock option's exercise price is higher than the value of the company's stock on vesting (*i.e.*, if it is "underwater"), but the stock price subsequently increases, it is unclear when and how any increase in the stock value between the vesting date and the eventual exercise date would be taxed (although, under basic tax principles, we presume that any future gain would be taxed as capital gain when the stock is sold). In any case, this

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provision would change the landscape of equity compensation dramatically and, if it is adopted, most currently prevalent award types likely no longer would be viewed as appropriate or desirable by companies.

Section 162(m) – Exceptions Limited and Coverage Expanded

- Section 162(m) of the Code limits the deductibility of compensation paid to certain top executive officers to $1 million. A significant exception to this general rule relates to performance-based compensation, including certain equity awards and appropriately structured bonus arrangements. Under the Proposal, the performance-based compensation exception would be completely eliminated. As Section 162(m) and its procedural and substantive requirements have contributed to the increase in performance-based compensation paid to top executives of public companies, the removal of this deduction opportunity could lead to a greater prevalence of compensation that is not payable solely on the achievement of objective performance goals, which is counter to current governance trends.
- Compounding the loss of the performance-based compensation deduction, the Proposal expands the reach of Section 162(m) by providing that once an individual has been a Section 162(m) covered individual for a company, any compensation paid in future years by the company to that individual — or even to his or her beneficiaries — will remain subject to the million-dollar deductibility cap. Finally, the Proposal adds the chief financial officer to the covered group, correcting a long-standing error in the Section 162(m) regulations and harmonizing Section 162(m) with Securities and Exchange Commission disclosure rules.

Qualified Plans – Limitations on Deferrals, Contributions, Benefits and Withdrawals

- Under current law, participants in 401(k) plans generally are permitted to defer $17,500 per year (as indexed) on a pre-tax basis. Under the Proposal, with respect to plans of employers with more than 100 employees, only half of this amount could be deferred on a pre-tax basis, with the rest deferred as Roth contributions (*i.e.*, on a post-tax basis). Employer contributions still would be deferred on a pre-tax basis. Interestingly, although this provision represents a net revenue loss for the government over the long term, it is included as a net revenue increase because of its effect during the 10-year so-called "budget scoring" period used by Congress for purposes of measuring the effects on the budget of proposed changes in tax law.
- Benefit and contribution limits for tax-qualified retirement plans would remain frozen for a full decade, and would resume indexing in 2024 based on the frozen 2014 levels.
- A 10 percent penalty tax is currently imposed on certain early withdrawals from qualified retirement plans in addition to any income taxes which may be due. One exception to this rule is an early distribution of up to $10,000 to pay first-time homebuyer expenses. This exception is repealed by the Proposal for distributions in 2015 and later.
- Under current law, distributions of employer securities held in defined contribution retirement plans may receive capital gains treatment. The Proposal repeals this special rule so that these stock distributions are taxed at ordinary income tax rates.

Withholding

- Current IRS guidance provides that certain qualifying severance payments are not subject to FICA tax withholding, and there have been recent conflicting court decisions with respect to the types of severance pay subject to withholding. Based on this lack of clarity, a number of companies have filed for refunds of such taxes paid in past years. The Proposal clarifies that all severance payments are subject to income and payroll tax withholding, including FICA withholding.
- Currently, employers who use professional employer organizations (PEOs) for services such as payroll and employment tax withholding remain liable for taxes due if the PEO fails to withhold or remit the taxes. Under the Proposal, PEOs may become certified by the IRS, and employers using a certified PEO will be released from liability for such taxes.

Certain Fringe Benefits

- Currently, certain fringe benefits provided to employees are not treated as taxable income, including qualified transportation benefits (up to $250 per month for qualified parking and up to $130 for transit passes). The Proposal freezes these amounts at current levels, with no future cost-of-living indexing.
- The value of employee achievement awards in recognition of an individual's length of service or safety record are no longer excluded from income and are fully taxable under the terms of the Proposal.

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The sweeping reforms contained in the Proposal already have sparked widespread debate, and if enacted even in a modified form will change the landscape of executive compensation and benefits significantly. We will continue to monitor developments closely as the tax reform debate evolves.

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