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## Executive Compensation

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### Camp Tax Reform Proposal Targets Executive Compensation

*Joseph S. Adams, Anne S. Becker, and Andrew C. Liazos*

On February 26, 2014, US House of Representatives Committee on Ways and Means Chairman Dave Camp (R-Mich.) released the proposed Tax Reform Act of 2014 (the Camp Proposal). In addition to simplifying the Internal Revenue Code (IRC) and reducing corporate and individual tax rates, the Camp Proposal would fundamentally change the income tax rules that apply to nonqualified deferred compensation arrangements and would further restrict tax deductions available to publicly held corporations when paying named executive officers. It would also impose a new excise tax on employees of certain tax-exempt organizations who receive excessive compensation and certain payments that are contingent upon a change in control.<sup>1</sup> Although unlikely to be enacted this year, the Camp Proposal provides a blueprint for other legislators to propose tax law changes that would significantly impact current executive compensation practices. Given the current political environment and the way tax revenue is estimated

Andrew C. Liazos (*aliazos@mwe.com*) and Joseph S. Adams (*jadams@mwe.com*) co-head the executive compensation practice at McDermott Will & Emery LLP and are fellows of the American College of Employee Benefits Counsel. Anne S. Becker (*abecker@mwe.com*) is a partner in McDermott's executive compensation group in Chicago. The authors gratefully acknowledge Ruth Wimer (*rwimer@mwe.com*), a partner in McDermott's executive compensation group in Washington, D.C., for her comments on this article.

by Congress when preparing budgets, it is likely that we have not seen the last of the executive compensation changes included in the Camp Proposal, which makes it important to understand how they work and what they would mean for current executive compensation programs.

### ***Section 409B: Changes to Nonqualified Deferred Compensation***

Current tax rules generally permit an employer<sup>2</sup> to defer compensation on an employee's behalf, on a vested or unvested basis, without triggering current income tax. A longstanding tax principle is that a cash basis taxpayer, such as an employee, is not subject to income taxes on unfunded deferred amounts until actual or constructive receipt of such amounts.<sup>3</sup> In response to perceived abuses of nonqualified deferred compensation plans, Congress enacted IRC Section 409A in 2004 to restrict the way compensation could be provided to an employee on a tax-deferred basis. But none of the changes under Section 409A altered the basic premise that an employer can design a nonqualified deferred compensation program so that an employee is subject to income tax only when payments are received under the plan. The historic counterweight to allowing tax-deferred compensation for the employee is that the employer generally cannot deduct compensation until it is paid to the employee.

The Camp Proposal would turn these fundamental tax rules on their head. Instead of being subject to income tax upon receipt of pay, a new IRC Section 409B would subject the employee to income tax on nonqualified deferred compensation upon vesting; that is, when compensation is no longer subject to a substantial risk of forfeiture. What will constitute nonqualified deferred compensation under Section 409B is potentially much broader than under Section 409A. As a practical matter, the employee would be subject to income tax in a manner similar to an accrual basis taxpayer.<sup>4</sup> As proposed, this change would apply to compensation earned by all employees with respect to services performed on and after January 2015, regardless of whether the employer were a taxable or nontaxable entity, or publicly or privately held.

Section 409B, if enacted, would have a profound impact on many common executive compensation arrangements. An employer would no longer be able to provide highly compensated employees the opportunity to defer salary and bonus on a tax-deferred basis outside of a cash or deferred arrangement under IRC Section 401(k). Plans designed to make highly compensated employees whole on a tax-deferred basis for employer contributions that cannot be made under a tax-qualified plan would become taxable upon vesting regardless of when payments were made. Even arrangements that are in no way abusive, such as installment payments made over a period of time linked to a noncomplete agreement, would be taxable prior to payment.<sup>5</sup>

Nonqualified deferred compensation under the Camp Proposal would even include stock options, stock appreciation rights, and similar compensation rights that are tied to stock price appreciation. As a result, these common forms of compensation, particularly at private equity portfolio companies, would be taxable upon vesting. How this rule would apply to a stock option during the remaining term after vesting is uncertain. For example, would there be a new taxable amount each trading day that the stock value increased after the option vested? Section 409B would tax deemed investment earnings. What happens if there were a stock value decrease? Would the loss be offset against prior gain? Or would there be some type of snapshot date for measuring gain? It is not difficult to imagine a myriad of valuation issues whenever there is a gap between vesting and payment of benefits for any type of nonqualified deferred compensation arrangement. What about capital gains on the sale of the underlying stock: When would the holding period begin?

Another significant problem that is not addressed by Section 409B is what happens if vested nonqualified deferred compensation is never received by the employee. The employee may have paid income tax without actually having received any payment. It is unclear whether a tax credit would be available to make the employee whole for the taxes paid on a benefit that was not received. If only a tax deduction is available, the employee may be in a worse position than if the compensation had never been provided.

### **Substantial Risk of Forfeiture Limited**

A particularly unsettling aspect of the Camp Proposal is that many types of arrangements that are currently considered to be *bona fide* vesting conditions under Section 409A would be disregarded under Section 409B. Currently, a substantial risk of forfeiture can include performance-related conditions, such as achieving a liquidity event within a stated period of time or a certain level of return to shareholders.<sup>6</sup> The Camp Proposal would treat compensation as subject to a substantial risk of forfeiture only if the employee's rights to such compensation were conditioned upon the future performance of substantial future services by that employee. This change would provide a tax incentive *not* to use performance-based vesting conditions for compensation arrangements unless payment was also tied to a service-based condition. Moving to a tax policy that provides an incentive to use compensation that is not tied to performance (or at least limits the types of compensation arrangements that can be used to incentivize performance) is directly at odds with institutional shareholder and corporate governance emphasis on "pay for performance," particularly in the public company context. It may also create significant difficulties in the private equity world with respect to compensation arrangements that only vest upon achieving liquidity and profitability goals.

## Transition Rules

Amounts earned *before* 2015 would generally be includible in income not later than: (1) 2022 or (2) the year in which the amounts are no longer subject to a substantial risk of forfeiture. These provisions would trigger immediate taxation to employees often without a corresponding distribution event and, as a result, necessitate the redesign of nearly every nonqualified deferred compensation plan. For example, a fully vested deferred amount for a 45-year-old participant that is not payable until retirement at age 62 would be taxable in 2022. It appears that Section 409A would continue to apply to amounts earned before 2015. However, the Camp Proposal would direct the US Department of the Treasury to issue guidance providing a limited window during which non-qualified deferred compensation plans could be amended without violating Section 409A to conform the date of distribution to the date the amounts are required to be included in income under Section 409B.

## Projected Revenue

According to the Joint Committee on Taxation, Section 409B is budgeted to raise \$9.2 billion in revenue from 2014 to 2023. This revenue estimate reflects that nonqualified deferred compensation will become taxable income sooner than under current law and that the effective income tax rate for employees receiving this type of compensation will be higher than for corporate taxpayers.

## ***Implications***

### Eliminate Deferrals?

Significantly, if the Camp Proposal is enacted, there would no longer be the current tax-advantaged reason to use nonqualified deferred compensation plans and, as a result, there may be an incentive to discontinue them unless they are funded or unless special circumstances apply. Many tax-exempt or potentially tax-exempt employers are subject to rules under current law (IRC Section 457 and 457A) that are similar in effect to those contained in the Camp Proposal. To avoid a situation in which employees have taxation but no cash to pay the tax bill, many of those employers pay the amounts upon vesting (and current IRC Section 409A envisions such a payment). Of course, there may be other nontax reasons to defer payment even after vesting, such as being able to link payments to compliance with noncompete obligations or having payments made after the end of a compensation recovery period under Dodd-Frank so that there would be no need to later claw back incentive compensation payments.<sup>7</sup>

## Delay Vesting?

If the Camp Proposal were enacted, some employers may, as a result, change their practices regarding performance-based pay. For example, nonqualified deferred compensation plans could become vested only upon retirement or upon termination of employment without cause or for good reason. This type of change would actually prolong the tax deferral. Using these types of vesting conditions would increase the importance of the definitions of “without cause” or “for good reason” included in the employee’s employment agreement and other compensation arrangements.

## Increase Deferrals Now—to the Extent Possible

If the Camp Proposal were enacted, opportunities for deferring compensation would be severely limited after 2014. As a result, certain employees may want to consider whether to make larger deferrals today, while they still can. Great care must be exercised in making such elections, as the current IRC Section 409A rules significantly restrict the ability to change these elections without triggering a 20 percent penalty.<sup>8</sup> Further, as noted above, all pre-2015 deferrals would be required to be taken into income on or before December 31, 2022 (or upon the lapse of a substantial risk of forfeiture, if later), and it appears Section 409A would continue to apply until such date.

## Stock Option Reloads Revisited?

As noted previously, if the Camp Proposal, as written, were to become law, stock options and stock appreciation rights would be treated as nonqualified deferred compensation. One approach that might be used to address this issue would be to grant a form of reload stock option. Specifically, when the stock option vested, an amount equal to the option spread (that is, the difference between the stock value and the exercise price) would be paid to the employee. To make the employee whole for the loss of potential future stock value appreciation, the employer could grant an additional reload option position with an exercise price equal to the then-current value of the stock with a new vesting condition. This option would make the employee whole for the early exercise of the prior option by preserving future potential upside due to subsequent appreciation of the company’s stock price.

## Funding—Secular Trusts

One form of compensation that might make a comeback if Section 409B is enacted is the secular trust. In contrast to a rabbi trust, a secular trust provides that trust assets are placed beyond the reach of the employer’s creditors. As a result, the employee is subject to tax prior to receiving amounts from the trust. If the employee is highly

compensated, which would normally be the case for this type of arrangement, the employee is taxed on the value of his or her interest in the secular trust when it is substantially vested, and annually thereafter on any incremental increase in value. In addition, the secular trust would be considered to be a separate taxable entity, and income earned by the trust would be taxable to the trust. The potential of this double taxation—at both the trust level and the employee level—made secular trusts unattractive as compared to traditional nonqualified deferred compensation except in extreme cases when the security of payment was paramount.

A secular trust would no longer be so disadvantageous if Section 409B is enacted. Secular trusts are taxable under IRC Section 402(b) and would appear to be exempt from Section 409B. As a result, it may be possible to use vesting conditions for a secular trust that would avoid income taxation (that is, performance vesting conditions) that would otherwise be ignored under Section 409B. In addition, once the benefit had become vested, the participant would avoid the risk of benefits not being paid due to the employer's bankruptcy or insolvency. Tax on amounts earned by the secular trust could be avoided by using tax-exempt investments such as tax-exempt bonds and insurance products.

### ***Changes to IRC Section 162(m)***

#### **Current Rules**

IRC Section 162(m) currently limits to \$1 million the deduction that public companies may take on the compensation paid to the chief executive officer and the next three highest paid officers. In addition:

- Chief financial officers generally are not subject to Section 162(m) due to a change in SEC proxy disclosure rules in 2007.
- Payments that qualify as commission-based compensation or performance-based compensation under Section 162(m) are not subject to the \$1 million limit.
- The limit applies only to named executive officers in the employer's proxy who are employed by the employer on the last day of the employer's fiscal year.

#### ***Proposed Changes***

The Camp Proposal would expand the application of Section 162(m) to:

- Cover the chief financial officer;
- Eliminate the commission-based compensation exception and the performance-based compensation exception (so that

such items as stock options and other performance-based pay would, for the first time, become subject to the \$1 million cap); and

- Continue to apply the deduction limit to former covered officers and to beneficiaries (which would eliminate the ability to preserve deductions by deferring amounts until employment termination and would necessitate complicated mechanisms for tracking former employees' deferred amounts).

According to the Joint Committee on Taxation, this portion of the Camp Proposal is budgeted to raise \$12.1 billion in revenue from 2014 to 2023. This change had previously been proposed and recently was included as part of the 21st Century Worker Tax Cut Act to fund the expansion of the Earned Income Tax Credit for low-income wage earners. It is reasonable to anticipate that members of Congress will continue to target changes to Section 162(m) to fund other legislative proposals.

The Camp Proposal does not go as far as expanding the restrictive rules of Section 162(m)(6). Under that section, added by the Patient Protection and Affordable Care Act (PPACA) and applicable with respect to services provided by individuals to certain health insurance providers: (1) the deduction is limited to \$500,000 (rather than \$1 million), and (2) the limit applies to all employees of a health insurance provider not just named executive officers.

### ***Implications***

#### **Implication 1: The Impact Could Apply to Past Years as Well as Future Years**

These proposed rules would apply to amounts paid after December 31, 2014. To ensure deductibility, many companies defer nondeductible amounts until the named executive officer retires or otherwise terminates employment with the company and is no longer subject to IRC Section 162(m). If the Camp Proposal's new approach to retired employees becomes law, then contrary to the company and the employee's intent under existing law, those deferred amounts would be subject to the limits of Section 162(m). This could have a particularly significant impact in 2022, when the grandfathering of pre-2015 deferrals to nonqualified deferred compensation plans would be due to expire as described previously under Section 409B.

#### **Implication 2: More Freedom in Designing Executive Compensation Programs**

The elimination of the performance-based compensation exception to the \$1 million deduction limit proposed in both the Camp

Proposal and the 21st Century Worker Tax Cut Act would be significant. For senior executives in public companies, performance-based equity compensation is generally the largest portion of their total compensation packages because it is believed to align company management with shareholders. The changes to Section 162(m) proposed in the Camp Proposal would remove significant tax incentives to provide compensation in certain ways, in particular, to meet the definition of performance-based compensation. Although the early consensus appears to be that the proposal will not affect the movement toward “pay for performance” for other purposes (for example, for shareholder “say on pay” votes), it likely will affect the vehicles and approaches used to implement “pay for performance.” Here are some examples:

- Companies may no longer feel compelled to set performance metrics during the first 90 days of a performance period as many companies now do in order to qualify for the existing performance-based exception to Section 162(m);
- It would be easier for companies to use more subjective performance metrics (for example, “Did the employee successfully change the ‘look and feel’ of the company’s retail stores?”) than under current rules requiring objective standards; and
- It would be easier to use “upward” discretion (that is, to pay *more* than the bonus amount generated under the incentive compensation formula would dictate based on company performance) if the compensation committee felt that was advisable. Under current Section 162(m) rules, only downward or negative discretion is permissible.

### ***The Road Ahead***

The US House of Representatives Committee on Ways and Means released a description of the Camp Proposal that provides a strong indication of the road ahead. The description characterizes the current tax treatment of nonqualified deferred compensation as “special tax-exempt treatment—courtesy of hardworking taxpayers.” Repealing longstanding tax principles that individuals are only taxed upon receipt of payments seems more like a punishment than a cancellation of a tax subsidy. However, so long as tax reform proposals can be structured to raise significant revenue from politically vulnerable executives, it is reasonable to expect more of these types of proposals to be introduced in the future. Employers—and executives—ignore them at their peril.

## Notes

1. The 25 percent excise tax that the Camp Proposal would apply to compensation over \$1 million paid to one of the five highest-paid employees of certain tax-exempt organizations and excess parachute payments made to these employees in connection with a change in control is outside the scope of this article.
2. Special rules under IRC Section 457 (with respect to tax-exempt employers) and Section 457A (with respect to certain non-US corporations and partnerships located in tax-indifferent jurisdictions) significantly restrict the way tax-deferred compensation may be provided to US taxpayers. These limits apply, in the case of Section 457, or suffer significant loss of the deduction in the case of Section 457A, in large part because these entities do not lose any current US income tax deduction by providing nonqualified deferred compensation (*i.e.*, there is not a significant tax detriment to the employer based on whether compensation is paid on a current or deferred basis).
3. *See* IRC Section 451 (regarding when an employee is considered in constructive receipt of a payment). Unlike income taxes, employment taxes (FICA) are triggered upon vesting under IRC Section 3121(v).
4. Indeed, an employee would be in even a worse position than an accrual basis taxpayer. Typically, an amount accrues for tax purposes only when all events have occurred to establish the right of payment. The Camp Proposal would deem an employee to have earned compensation even though it may never be received due to forfeiture conditions that are disregarded under Section 409B.
5. Similar to Section 409A, Section 409B would not treat potential forfeiture under noncompete obligations as a substantial risk of forfeiture.
6. *See* Treas. Reg. § 1.409-1(d) (defining a substantial risk of forfeiture to include “forfeiture if entitlement to the amount is conditioned on...the occurrence of a condition related to a purpose of the compensation....[such that it] relate[s] to the service provider’s performance for the service recipient or the service recipient’s business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering”).
7. Section 954 of the Dodd-Frank Act, when implemented by the national securities exchanges, will require executive officers to repay certain types of incentive compensation to public companies in the event of a financial restatement under certain circumstances during a three-year look-back period.
8. Accelerated payment of nonqualified deferred compensation violates Section 409A except in relatively rare situations permitted under final Treasury regulations.

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