SULLIVAN & CROMWELL LLP

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# Tax Reform Bill Proposes Significant Compensation Changes

## Tax Reform Proposal Would Eliminate Nonqualified Deferred Compensation, Limit Deductions for Payments to Highly Compensated Officers and Restrict Compensation for Tax-Exempt Organizations

### SUMMARY


On November 2, 2017, the House of Representatives Ways and Means Committee released the first draft of its tax reform bill (the "Proposed Bill"). The Proposed Bill would make significant changes to the taxation of deferred compensation and would revise and increase the limitations on payments to highly compensated employees. However, other discussed changes to qualified plans such as "Rothification" or lowered limits on qualified plan contributions were not included. Most notably, the Proposed Bill would:

- Eliminate nonqualified deferred compensation, by requiring income inclusion when compensation (including stock options) is no longer subject to a service-based vesting requirement and repealing prospectively Sections 409A and 457A of the Internal Revenue Code.
- Eliminate the performance-based and commissions exceptions to the Section 162(m) $1 million deduction limit for compensation paid to covered employees and extend the Section 162(m) limit to the CFO and previous years' covered employees without transition relief (meaning this limit would apply to currently outstanding performance-based awards, stock options and stock appreciation rights that pay out after 2017).
- Apply a 20% excise tax to certain highly compensated employees of tax-exempt organizations that generally tracks the Section 162(m) limitation on compensation deductions for publicly traded corporations.


### BACKGROUND

Under current law, nonqualified deferred compensation plans that comply with Section 409A may permit employees to delay including compensation in income until payment is actually made (even if there is not a substantial risk of forfeiture before payment). If a plan fails to comply with Section 409A, employees are subject to an immediate income inclusion as well as additional tax and interest on amounts previously deferred. Section 457A applies to deferred compensation received from tax-indifferent parties (*e.g.*, foreign organizations) and generally requires an income inclusion when there is no substantial risk of forfeiture.

Current Section 162(m) generally limits a publicly traded corporation's ability to deduct compensation in excess of $1 million paid to "covered employees." Due to a discrepancy between the existing text of Section 162(m) and SEC proxy disclosure requirements, the IRS has interpreted "covered employee" to mean the CEO and the three highest compensated officers (other than the CFO). Additionally, this deduction limitation does not apply to performance-based pay (including stock options) or commissions. Under current law, tax-exempt organizations do not have a restriction on compensation analogous to the 162(m) deduction limitation.

## THE PROPOSED BILL

### A. TREATMENT OF DEFERRED COMPENSATION

The Proposed Bill would effectively eliminate deferred compensation by replacing Sections 409A and 457A with a new Section 409B, which would generally require an income inclusion when compensation is no longer subject to a service-based vesting requirement. Amounts includable under Section 409B would generally be treated as wages for reporting and withholding purposes. Additionally, Section 409B would provide the Treasury Department broad authority to issue regulations necessary or appropriate to carry out the purposes of 409B.

#### 1. Inclusion in Income

The new Section 409B would cause compensation under nonqualified deferred compensation plans to be includable in income on vesting (*i.e.,* when there is no longer a service-based substantial risk of forfeiture). However, compensation paid within 2½ months after the end of the year in which there is no longer a substantial risk of forfeiture would not be treated as deferred. A nonqualified deferred compensation plan—defined broadly to include agreements and arrangements—would include any plan that provides for a deferral of compensation other than (1) qualified employer plans, (2) bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans, or (3) other plans prescribed by regulations. The definition would also exclude plans consisting of certain nonexempt trusts and transfers of property in exchange for services described in Section 83 (other than stock options). New Section 409B would also expand the definition of deferred compensation to include equity-based compensation in the form of restricted stock units, stock options and stock appreciation rights, which would effectively eliminate the utility of stock options and stock appreciation rights as a form of incentive compensation.

Additionally, Section 409B would provide a narrow definition of substantial risk of forfeiture that applies only where the right to the deferred compensation is conditioned on the future performance of substantial services. Alone, a covenant not to compete or performance-based vesting conditions would not create a substantial risk of forfeiture. As a practical matter, this would likely mean that compensation could not be deferred beyond service-based vesting other than pursuant to tax-qualified employer plans.

### 2. Effective Date and Transition Rules

Section 409B would generally be effective for services provided beginning in 2018. Existing deferrals (those for compensation relating to services performed prior to 2018) would be included in income in the last taxable year beginning before 2026, or, if later, when such amounts are no longer subject to a substantial risk of forfeiture.

Additionally, the Proposed Bill calls for the Treasury Department to issue guidance that provides a limited time to amend existing nonqualified deferred compensation arrangements so that distribution dates align with the service provider's income inclusion. Amendments under these transition rules would not violate the requirements of Section 409A or be treated as a material modification of the arrangement for purposes of Section 409A.

## B. RESTRICTIONS ON DEDUCTIONS FOR "EXCESSIVE EMPLOYEE REMUNERATION"

The Proposed Bill realigns the definition of "covered employee" with SEC compensation disclosure requirements, with the result that the limitation would apply to the CFO (in addition to the CEO and three other highest paid officers covered under current law). Significantly, the $1 million deduction limitation under Section 162(m) would apply not only to covered employees in the relevant tax year, but also to any person that was a covered employee in any tax year after December 31, 2016 for as long as that person (or a beneficiary) continued to receive remuneration. Further, the definition of remuneration is expanded under the Proposed Bill to include amounts paid to beneficiaries of a covered employee.

Additionally, the Proposed Bill removes the exception for commissions and performance-based compensation, including stock options. Accordingly, these forms of compensation paid to covered employees would also be subject to the deduction limitation. Because the proposed amendments eliminating performance-based compensation would be effective for taxable years beginning after December 31, 2017, it appears that any currently outstanding stock options, stock appreciation rights and other performance-based compensation that become payable in future years would be subject to the $1 million deduction limit.

The scope of employers covered by the rule would also be expanded to include not just companies whose securities are required to be registered, but also companies subject to certain filing requirements.

These rules would be effective for taxable years beginning after 2017, though the inclusion of previous covered employees means that in 2018 the limitation would apply to compensation paid to 2018 covered employees and to 2017 covered employees (or their beneficiaries).

## C. EXCISE TAX ON CERTAIN TAX-EXEMPT ORGANIZATION COMPENSATION

The Proposed Bill would create a 20% excise tax on compensation in excess of $1,000,000 paid to covered employees at Section 501(a) exempt organizations, farmer’s cooperatives, Section 527 political organizations and organizations with income from public utilities or essential governmental functions. For these exempt organizations, the covered employees would be the five highest compensated employees in the organization in a taxable year as well as any person that was a covered employee for any taxable year beginning in 2017. The excise tax would apply to wages (excluding designated Roth contributions) and excess parachute payments (generally a payment contingent on the employee’s separation from the employer that has a present value greater than three times the employee’s base compensation).

The excise tax would be imposed on the organization rather than the employee and would apply to payments received from related organizations. Where related organizations contribute to a covered employee’s remuneration, each organization would be liable for the tax in proportion to the amount that organization contributed to the covered employee’s total remuneration.

This rule would take effect for tax years beginning after December 31, 2017.

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