



AMERICAN BENEFITS COUNCIL

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A NEW TAX ON EMPLOYEE INCENTIVES: HARMING ECONOMIC GROWTH AND TAXING EMPLOYEES ON ILLUSORY INCOME

Tax reform legislation now under consideration in the U.S. Senate Finance Committee includes the imposition of a new tax on (1) incentive compensation arrangements that allow broad groups of employees to share in the success of the employer, and (2) deferred compensation that is directly linked to the retirement benefits provided to rank-and-file employees.

- The effect of the new tax will be far less such incentive compensation, eliminating a powerful means of motivating and rewarding employees and spurring economic growth. These incentives are commonly provided to a broad group of employees, not just top executives, and in many cases are the only feasible way for some growing companies to attract and retain talent.
- Moreover, *in many cases, this new tax will be imposed on income that will never be received*, as illustrated below.
- The new tax would also significantly undermine management employees' incentives to provide the current levels of qualified retirement benefits to rank and file employees. This would occur because management employees' nonqualified benefits could effectively no longer be based on qualified plan benefits.
- The full value of severance benefits paid over time would become immediately taxable, inappropriately putting financially vulnerable rank and file employees into higher tax brackets.
- The new tax would apply to employees of tax-exempt organizations, undermining their important mission.

- The mandatory taxation in 2026 of deferred compensation earned before 2018 will lead to adverse results. Companies can in many cases be effectively forced to pay out this amount so that employees have the cash to pay the taxes. This can create cash flow issues, especially for smaller organizations. This large lump sum payout can also throw employees into inappropriately high tax brackets, disrupting retirement plans.
- The provision would create untold complexities for which there are no apparent answers, including, for example, (1) unanswerable valuation issues and (2) difficult issues related to partnerships that have been long reserved for further study by the government, as discussed below.

This provision, which is scheduled to become effective in just a few weeks, needs to be withdrawn and reevaluated. It goes without saying that the compensation packages of employers across the country cannot be restructured in a matter of a few weeks or less, making the effective date unworkable. But changing the effective date alone would not solve the fundamental substantive concerns companies have with the proposal.

DESCRIPTION OF THE BILL PROVISION

The bill would modify the treatment of nonqualified deferred compensation (“NQDC”). By definition, NQDC does not receive the favorable tax treatment and protections from creditors available to qualified plans. For example, the employer cannot deduct the compensation until it is taxable; earnings on the deferred amounts are subject to tax; and distributions cannot be rolled over.

Under the bill, the value of NQDC, including earnings, would be taxable when it is vested. For this purpose, surprisingly, stock options and other stock appreciation rights (including restricted stock units) would be treated as NQDC, meaning that stock options and other stock appreciation rights would need to be valued and taxed as soon as they are vested.

Certain transfers of property would be exempt, as would qualified plans, including governmental 457(b) plans.

This provision would apply to compensation for services after 2017. In addition, all NQDC attributable to pre-2018 services becomes taxable in 2026.

EFFECT ON INCENTIVE COMPENSATION

One of the great success stories of our modern workforce is the widespread use of incentive compensation that allows employees to share in the financial growth of the

employer. This can be done in many ways, such as stock options, stock appreciation rights, restricted stock units, and other arrangements based directly on the profitability or revenues of the employer. The vast majority of these arrangements, including many of the most popular, would become taxable under the bill.¹¹

The bill would result in widespread termination of many types of incentive compensation programs. Employers generally cannot provide benefits that become taxable before employees have the cash to pay the taxes imposed.

The effects of the termination of these broad-based programs will be most acutely felt by middle managers. Long-service managers can benefit greatly by sharing in the success of the employer.

Even more fundamentally, the economy will suffer. Giving employees a stake in the employer has undeniably beneficial effects on employee loyalty and motivation, spurring the amazing growth we have seen in our economy. Especially in the new economy, this means of providing compensation is part of the culture of companies, tying employees and employers together in a joint mission to succeed.

And for many companies without abundant cash, there is no other way to attract and incentivize talent. Many of today's corporate giants did not exist 30 years ago, and would not exist today if this rule had been in effect.

TAXING ILLUSORY COMPENSATION

Assume that the option price of a stock is \$50, and assume further that when the stock option vests, the stock is worth \$55. Under the proposal, as we understand it, the employee would be taxed immediately on \$5, i.e., the difference between the price and the value of the stock. Assume that the employee does not exercise the option. What happens if the next year the stock falls in value to \$47? As we understand it, there is no provision allowing a deduction for the \$5 of income that was taxed, but that no longer exists and may never exist. In other words, the employee is taxed on illusory income that he or she may never receive.

This taxation of illusory compensation will be very common with respect to incentive compensation, but the problem is also broader than that. As discussed below, the same problem will arise in the context of SERPs.

¹¹ The explanation of the bill indicates that incentive stock options under Code Section 422 and employee stock purchase plans under Code Section 423 are exempt from the proposal.

UNDERMINING QUALIFIED RETIREMENT PLANS

It is very common for companies to provide their higher paid employees, including middle managers, with “excess” plans – often referred to as “SERPs” -- that make up for the benefits that cannot be received under the company’s qualified plan by reason of various qualified plan limits on contributions or compensation. Under the bill, these SERPs will be taxable when vested, which poses severe problems.

First, as noted above, if the benefits under these SERPs become taxable when vested, the SERPs will largely disappear, because it is not workable to tax employees on benefits before they have the cash to pay the tax.

Moreover, SERPs can raise the same illusory compensation issue noted above. For example, assume that a company maintains a defined benefit SERP that provides benefits to employees that cannot be paid from the company’s qualified defined benefit plan by reason of the limits on benefits and compensation. In effect, the SERP pays the full benefit payable under the qualified defined benefit plan as promised, determined without applicable limits, offset by what is payable under the qualified plan. The “excess” can grow or shrink; for example, in a year in which the compensation and benefit limits are indexed, the excess can shrink. This means that the larger excess taxed in the prior year was illusory income that may never be received.

What would the end of SERPs mean? Two things: first, these SERPs provide meaningful retirement benefits to many middle managers – these arrangements are not just limited to top executives. *In fact, in some companies, literally thousands of employees are covered by these arrangements.* Secondly, and very importantly, these SERPs can undermine management interest in preserving a strong and vibrant qualified plan, since the SERP benefits are directly tied to the promised qualified plan benefit formula. Without the SERP, the qualified plan benefits become far less relevant to management, giving them far less personal stake in maintaining high benefit levels.

SEVERANCE BENEFITS WOULD BECOME IMMEDIATELY TAXABLE

The proposal applies to severance benefits. So, for example, assume that an employee is terminated in November and is entitled to two years of severance benefits paid monthly. The value of the entire two years of severance benefits would become immediately taxable, putting that employee into an inappropriately high tax bracket at exactly the time that his or her situation is the most difficult.

APPLICATION TO EMPLOYEES OF TAX-EXEMPT ORGANIZATIONS

References to “nonqualified deferred compensation” can conjure up images of CEOs of Fortune 500 companies, but the issue is far broader than that, as discussed above. In addition, the bill provision reaches all the way to key employees of tax-exempt organizations who often make far less than middle managers at a large company. We see no policy reason to disturb the worthy mission of tax-exempt organizations with such a drastic change in their ability to attract and retain key personnel.

CASH-OUT IN 2026 CREATES HARDSHIPS

The mandatory taxation in 2026 of deferred compensation earned before 2018 will lead to adverse results. Companies can in many cases be forced to pay out this amount so that employees have the cash to pay the taxes. This can create cash flow issues, especially for smaller organizations. It can also throw employees into inappropriately high tax brackets, disrupting retirement plans.

COMPLEXITIES ABOUND

In the short time since introduction of H.R. 1, we have barely had the chance to scratch the surface of the issues with this provision. For example, the proposal will require valuation of future promises for which there is no workable means of valuation. How will that work? For example, how would we value the right today to receive a share of cumulative corporate profits at some future date?

Does the bill provision apply to partnerships? If so, how? In the preamble to the Section 409A regulations (addressing restrictions on nonqualified deferred compensation), Treasury explicitly declined to address partnership issues because of all the unresolved technical issues:

The proposed regulations did not address the application of section 409A to arrangements between partnerships and partners, and these final regulations also do not address such arrangements. The statute and legislative history of section 409A do not specifically address arrangements between partnerships and partners providing services to a partnership and do not explicitly exclude such arrangements from the application of section 409A. Commentators raised a number of issues, relating to both the scope of the arrangements subject to section 409A and the coordination of the provisions of subchapter K and section 409A with respect to those arrangements subject to section 409A. The Treasury Department and the IRS are continuing to analyze the issues raised in this area.

The analysis by Treasury and the IRS of the partnership issues is ongoing. This tells us that the new bill provision has likely not been analyzed through the unique prism of partnership law. So it should be clarified that partnership arrangements are not subject

to the provision in H.R. 1. And if the law is not ready to deal with partnership issues, why should the law apply to corporate entities?

Taxing nonqualified deferred compensation is a complicated issue with far-reaching effects on the engine that drives the economy: the American worker. We urge you to reconsider the bill's provision until all of the technical and economic effects can be fully analyzed and policy goals are more publicly debated.