AMERICAN BENEFITS COUNCIL

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PROTECTING INCENTIVES FOR ECONOMIC GROWTH

The Tax Cuts and Jobs Act passed by the U.S. Senate and House of Representatives would, in many cases, deny deductions to employers that provide incentive compensation to their top executives. This provision would undermine the types of compensation arrangements that have spurred so much economic growth and thus should be deleted from the bill. The bill would also impose a parallel, inappropriate excise tax on tax-exempt organizations trying to further their worthy mission.

Current law

Under current law, publicly traded corporations may not deduct compensation paid to certain top executives in excess of $1 million. Certain compensation is exempt from this rule, including (1) performance-based compensation, such as stock options and stock appreciation rights, (2) commissions, and (3) compensation paid after an employee ceases to be within the top executive group.

Proposal

The proposal modifies current law in the following respects:

- The definition of the top executives subject to the deduction denial would be modified, and extended to apply to all employees who were within the top executive group at any time after the 2016 tax year, as well as their beneficiaries or former spouses. Thus, for example, compensation payable to a top executive who has retired would be subject to the deduction denial.
- The types of companies subject to the deduction denial would be expanded.
- Commissions and performance-based compensation would become subject to the deduction denial.

In addition, the bill would impose a 20% excise tax on tax-exempt organizations to the extent that they pay to one of their five highest paid employees either (1)

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compensation in excess of $1 million, or (2) "excess parachute payments" contingent on the employee's separation from service.

These provisions would become effective for the 2018 tax year.

Performance-based compensation should be encouraged, not penalized.

We believe that it would be harmful to our economy to undermine commission and other performance-based compensation arrangements by subjecting such arrangements to the deduction denial. 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, and other arrangements based directly on the financial performance of the employer.

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. Paying employees based on performance is also consistent with recent corporate governance reforms and best practices that favor performance-based compensation programs.

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 these rules had been in effect.

It is true that many companies may continue to provide incentive compensation despite the deduction denial. But that simply means that the companies that are producing the greatest economic growth are being penalized the most by having the largest deduction denial. If the objective is economic growth, it seems counterproductive to penalize most heavily the companies producing the greatest growth.

SERPs are beneficial and should not be penalized.

It is very common for companies to provide their higher paid employees 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 House and Senate proposals, many benefits paid pursuant to these SERPs will be nondeductible, which is effectively a tax penalty on employers for providing these SERPs.

This could discourage employers from providing these SERPs. If the most productive employees are prohibited from benefiting from these SERPs, it can in many cases undermine the maintenance of the entire SERP, causing employers to seek other ways to compensate employees that do not trigger a tax penalty.

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.

Covered employee status should be limited to five employees.

Under the proposals, once an employee becomes a covered employee subject to the deduction denial or the 20% excise tax, he or she is permanently a covered employee, regardless of whether he or she steps down to a different job, terminates employment, or even dies.[1] This is a very severe rule that will arbitrarily penalize companies that have change among their top executives. For example, a company undergoing changes could have 15 covered employees at a time when a comparable company with little change may have five covered employees. The former company will have three times the tax penalty as the latter company.

A far better result would be to have no more than five covered employees at any one time. The five could be those who would generate the largest deduction denial (or excise tax). That approach solves the problem of compensation paid to former employees avoiding the tax penalty. At the same time, this approach avoids the severe inequity of companies with change at the top suffering unjustified tax burdens.

We would also ask that neither the deduction denial nor the 20% excise tax apply to payments to beneficiaries. Beneficiaries are not necessarily wealthy, and in combination with payments to many other beneficiaries, smaller payments, such as $50,000, could trigger a tax penalty. We fear that the proposed rule could result in far fewer benefits flowing to beneficiaries, which is not the true target of this rule.

Tax-exempt organizations should not be penalized.

[1] It is unclear if the 20% excise tax applies post-death with respect to the employee's beneficiaries; the deduction denial clearly does.

Tax-exempt organizations do not have any profit that inures to the benefit of any individual. They should not be treated as if they do have such profits. Tax exempt employers pay compensation based on fair market value, that is, the amount required to attract talent in the marketplace. The exemption from the compensation limit is a key tool that helps organizations with a meaningful and worthy purpose attract and retain critical senior leadership and talent.

Transition relief is critical.

Even with the above changes to the deduction denial and excise tax, transition relief is critical in two respects. First, 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. No change should apply until at least 2019.

Second, it would be unfair not to protect amounts payable pursuant to a binding contract currently in effect. When the deduction denial was first enacted, there was a binding contract exemption. Please see Code section 162(m)(4)(D). There is no policy reason not to provide the same type of exemption now. Such a binding contract transition rule is in the Senate proposal on deduction denials, but not in the House bill. And such a binding contract transition is in neither proposal with respect to the 20% excise tax on tax-exempt organizations.

With respect to the binding contract exception, grants of options, restricted stock, restricted stock units, and similar benefits should be treated as binding contracts because they are binding on the employer at the time of grant, and it is the employer that bears the brunt of the tax penalty.

Input still being gathered

We are very concerned about the pace with which these provisions could be considered. We are still in the process of receiving input on the host of issues raised, including the expansion of the companies subject to the deduction denial. We urge Congress not to adopt this provision before we have all had the time to consider its effects and policy ramifications.