Published on *The National Law Review* https://natlawreview.com

House Tax Bill Would Gut Deferred Compensation Plans and Curtail Executive Pay Deductions

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Summary

The US House of Representatives Committee on Ways and Means proposed Tax Cuts and Jobs Act intends to reduce corporate and individual tax rates. To pay for the proposed changes, the House Tax Bill would, if enacted, negatively impact long-standing current executive compensation practices.

In Depth

On November 2, 2017, US House of Representatives Committee on Ways and Means released the proposed “Tax Cuts and Jobs Act” (the House Tax Bill) that, among other changes, would reduce corporate and individual tax rates. To pay for the proposed changes, the House Tax Bill would, if enacted, negatively impact long-standing current executive compensation practices.

Prohibition of Tax Deferral of Compensation beyond Vesting

The House Tax Bill would add new Section 409B that, if adopted, would result in nonqualified deferred compensation earned for services rendered after 2017 being taxed as soon as such compensation ceases to be subject to a substantial risk of forfeiture (typically, upon vesting). This provision would apply to publicly held companies, private corporations and tax exempt organizations. The House Tax Bill would also potentially impact deferred amounts relating to services performed *before* 2018 by requiring generally that such amounts be included in taxable income as of the later of: (1) the service provider’s last taxable year beginning before 2026 or (2) the year in which the amounts are no longer subject to a substantial risk of forfeiture.

A broad range of arrangements are considered deferred compensation for purposes of this proposed rule. In addition to traditional deferred compensation plans, certain types of severance arrangements and supplemental pensions would be included. Section 409B would also apply to equity-based compensation arrangements, including stock units (phantom stock), stock options and stock appreciation rights. The House Tax Bill would also limit the definition of a substantial risk of forfeiture to conditions tied to the future performance of services. Other types of popular forfeiture conditions, such as the occurrence of an IPO, a change in control or economic performance conditions, would no longer qualify as a substantial risk of forfeiture for these purposes.

If these provisions are enacted, it is reasonable to anticipate that employers would not continue nonqualified deferral compensation plans in their current form.

Changes to Internal Revenue Code Section 162(m)

Section 162(m) currently limits to $1 million the annual deductions that public companies may take on compensation paid to the chief executive officer and the next three highest paid officers. In addition, under current law:

- Qualifying performance-based compensation is exempt from $1 million limit
- Compensation paid to chief financial officers generally is not subject to Section 162(m)
- The deduction limit only applies to executive officers named in the Summary Compensation Table who are employed on the last day of the issuer's fiscal year

The House Bill would significantly alter the limitations imposed by Section 162(m) for tax years after 2017 by:

- Eliminating the performance-based compensation exception (so that items like stock options, stock appreciation rights and other performance-based pay would, for the first time, become subject to the $1 million deduction limit)
- Subjecting compensation paid to the chief financial officer to the deduction limitations
- Expanding the group of covered employees by applying the deduction limitation to individuals who at any time after 2016 were named executive officers as well as their beneficiaries (thereby eliminating the approach of preserving tax deductions by deferring amounts until a tax year after an executive terminates employment)

The House Tax Bill's Section 162(m) provisions remove significant tax incentives to provide incentive compensation in a particular manner. While this change will not likely impact the emphasis on pay-for-performance consistent with avoiding excessive risk taking, it could impact the way in which public companies structure incentive compensation. For example, companies may no longer feel compelled to set performance metrics during the first 90 days of a performance period as is currently required in order to qualify for the existing performance-based exception to Section 162(m).

National Law Review, Volume VII, Number 310