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Proposed Sweeping Changes to the Taxation of Executive Compensation

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Introduction

For the past several months, the business community has been focused on navigating the economic turmoil brought on by the COVID-19 pandemic. While many companies have experienced salary reductions, staff layoffs and furloughs, and corporate restructurings, there have been developments in the executive compensation arena that have gone largely unnoticed. One such development is a proposed reform that would lead to an acceleration of the taxation of certain forms of executive compensation.

On February 27, 2020, Senators Bernie Sanders of Vermont and Chris Van Hollen of Maryland introduced the "CEO and Worker Pension Fairness Act" in the U.S. Senate. [1] The proposed legislation was a response by Senators Sanders and Van Hollen to a recent report from the Government Accountability Office (GAO) commissioned by Senator Sanders: "Private Pensions: IRS and DOL Should Strengthen Oversight of Executive Retirement Plans." [2]

The legislative proposal would significantly change the tax treatment of two major elements of executive compensation: nonqualified deferred compensation plans and stock options. This taxation treatment found in the Sanders/Van Hollen legislative proposal was first proposed in 2016 by the Republican Party as part of the Trump administration's own tax reform legislation. The provisions in the Sanders and Van Hollen legislative proposal regarding the taxation of stock options upon vesting were ultimately removed from the Trump administration's major tax reform legislation enacted in December 2017: the "Tax Cuts and Jobs Act of 2017." [3]

Nonqualified Deferred Compensation

In today's corporate environment, there are two forms of nonqualified deferred compensation that are most prevalent: (1) an executive's ability to voluntarily elect to defer base salary or annual bonus, or some portions thereof, until retirement or some other specified future date; and (2) an

[1] "Sanders, Van Hollen Push to End CEO Tax Breaks to Protect 1.7 Million Workers' Pensions." Bernie Sanders Senator website. February 27, 2020. https://www.sanders.senate.gov/newsroom/press-releases/sanders-van-hollen-push-to-end-ceo-tax-breaks-to-protect-17-million-workers-pensions.

[2] Richard Rubin and Theo Francis. "Bernie Sanders Aims New Tax Hike at Executive Retirement Plans." The Wall Street Journal. February 27, 2020. https://www.wsj.com/articles/bernie-sanders-aims-new-tax-hike-at-executive-retirement-plans-11582815616.

[3] Kevin Brady. "Tax Cuts and Jobs Act." United States Congress website. December 22, 2017. https://www.congress.gov/bill/115th-congress/house-bill/1/text/.

executive's participation in a supplemental executive retirement plan (SERP) — an unfunded arrangement that provides additional retirement benefits to executives beyond those that are available through tax-qualified retirement plans. SERPs are considered an important retention tool. It has been our experience, as executive compensation consultants, that executive voluntary deferral elections are not as popular in today's environment as they have been in years past.

This decrease in prevalence of voluntary deferral elections may be attributed to two considerations. First, executives are inclined to believe that their current tax rate on ordinary income is relatively low and unlikely to be lower at retirement. Therefore, it might be unlikely that the executive's effective tax rate is going to be lower at retirement or at some other specified future date. The second reason that voluntary deferrals have declined is the introduction of Section 409A to the Internal Revenue Code ("IRC"). Several years ago, Section 409A was added to the IRC, and this provision has made it more onerous for an executive to defer either base salary or bonus under attractive terms. Section 409A has rigid requirements for the timing of deferral elections, prohibitions on the timing or scheduling payments on an accelerated basis, and other limitations, including the imposition of a 20 percent excise tax penalty should the deferral plan violate certain design or operational rules of the IRC provision.

The second form of nonqualified deferred compensation, the SERP arrangement, is the more popular form of deferred compensation. The aforementioned GAO study of the 500 largest U.S. companies found that there are approximately 2,300 executives covered by SERP arrangements in this sample of companies (based upon proxy disclosure of Named Executive Officers) and that these arrangements represent a total of approximately $13 billion in accumulated plan benefits. [4] There are two types of SERP arrangements that are prevalent in today's executive compensation environment. The first type of SERP is a plan which enhances prospective retirement benefits by considering additional elements of compensation (e.g., annual bonus) and/or increasing the benefit formula (e.g., adding years of credited service, increasing the contribution formula) above those available in the underlying qualified plan. The second type of SERP restores benefits that are lost in the qualified pension due to statutory limitations on compensation in the Internal Revenue Code. These latter types of plans, frequently referred to as restoration plans, are the most common type of SERP arrangement found in the marketplace today.

The new proposed tax legislation set forth by Sanders and Van Hollen would recognize taxable income to the executive when the nonqualified deferred compensation arrangement becomes vested—not when the deferred funds are received. This is a substantive change in taxation and could result in an executive being taxed even though they may not have access to the deferred funds (a highly paid executive must wait 6 months for the actual receipt of deferred monies after retirement or other official termination events under Section 409A).

Other substantive changes to the taxation of deferred compensation include the following:

- All revenue raised from the change in tax treatment would be transferred to the Pension Benefit Guaranty Corporation to shore up multiemployer pension plans (the estimated $13 to $15 billion accrued value in current pension values would result in lost corporate tax deductions for the same amount, but the resultant gain in tax income by the

[4] Brian Anderson. "Sanders Bill Seeks to Limit Executive Retirement Plans." 401k Specialist. March 2, 2020. https://401kspecialistmag.com/sanders-bill-seeks-to-limit-executive-retirement-plans/.

government would not go far in closing the estimated $1.28 trillion funding gap in multiemployer pensions). [5]

- The proposed legislation requests that the Department of the Treasury and the Department of Labor implement changes to the Tax Code recommended in the GAO report, including a formal definition of employee eligibility as well as new disclosure requirements of nonqualified deferral plans.
- The bill will also require increased disclosure of deferred compensation by requiring such compensation be disclosed on Form W-2 on a mandatory basis (currently a voluntary provision).

Stock Options and Stock Appreciation Rights

The proposed tax legislation will require that all employees earning at least $130,000 annually be taxed on nonqualified stock option gains in excess of $100,000 at the time of vesting (the first $100,000 will be exempt). This is a departure from current tax rules which require that the gains recognized on stock options be taxed at the time of exercise. [6] While stock options have declined in prevalence, many companies still use them as part of their executive stock incentives. This tax proposal will reduce their incentive effect.

Stock options are typically granted with a stated term of 7 to 10 years. Options are normally granted with an exercise price ("strike price") equal to the stock's fair market value on the date of grant. Most option plans are designed to be fully vested after 3 to 4 years of service, leaving the executive with the ability to time their decision to exercise from the vesting date to the end of the option's term. The executive's decision to exercise their stock options is typically predicated on the stock's current share price and the amount of potential gain to be realized, the executive's access to capital to pay for the option exercise price and the accompanying tax liability, and other personal considerations.

The amount of tax to the individual executive on the exercise of a nonqualified stock option is the gain in share price from the grant date to the exercise date, with the gain being taxed as ordinary income. The company receives a tax deduction equal to the gain realized by the executive in the year in which the exercise occurs.

The Sanders and Van Hollen tax proposal has several unusual features that will require further clarification. Vested gains above the initial $100,000 are taxable. This will be especially problematic for executives in startup companies that may be privately owned and may not have marketability of their company shares. Also, the tax legislation does not have a grandfather clause, but the proposed bill does include a 9-year transition period so that the executive could have until 2029 to settle their tax liability. [6]

As we noted in the Introduction section of this post, the taxation of stock options at the vesting date was initially proposed in some preliminary versions of the 2017 tax reform legislation. When

[5] Lauren Feiner. "Sanders' New Tax Policy Raises Alarms in Silicon Valley." CNBC. February 28, 2020. https://www.cnbc.com/2020/02/28/sanders-new-tax-policy-silicon-valley-reactions.html.

[6] Dan Primack. "Bernie's Plan to Hike Taxes on Some Startup Employees." Axios. February 28, 2020. https://www.axios.com/bernie-sanders-tax-proposal-973ef0b3-06e8-4a76-b15b-5ecbe1bb2a80.html.

this concept was floated to the business community at that time, the reaction of corporate America was unfavorable.

Pay Governance Commentary

The concept of taxing individual executives at the time of vesting without the receipt of the income would negatively impact the current executive compensation environment. Although some critics may believe that executives are overpaid and under-taxed, the notion of taxing an executive when they have yet to receive their deferred funds or stock option gains is atypical. Taxation at the time of vesting would require a major overhaul of the Tax Code, and such tax concepts as constructive receipt, risk of forfeiture, and other elements of the Tax Code would need to be rewritten.