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Executive Pay Not Immune to Proposed Tax Reforms

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On February 21, 2014, House Ways and Means Committee Chairman Dave Camp introduced a discussion draft/blue print of legislation (Tax Reform Act of 2014) that would cover a wide range of tax areas. It is very unlikely that all the items in the discussion draft will make its way into legislation during the current Congressional session, but some suggest it signals where the House and Senate may focus attention as the effort to reform the tax code makes its way through the Congressional labyrinth. There are several items in the discussion draft related to executive compensation we will be monitoring:

Nonqualified deferred compensation related to services performed after 2014 would be subject to income tax when vested. This would parallel existing rules found under Code Section 457(f) for taxexempt organizations. The discussion draft provides that "current-law rules would continue to apply to existing non-qualified deferred compensation arrangements until the last tax year beginning before 2023, when such arrangements would become subject to the provision." It is unclear whether this means all amounts deferred prior to 2014 would immediately be taxed in 2023 (if not already taxed) or if amounts earned prior to 2014 and vested after 2013 would be taxed when vesting occurs. Given the enormous amount of time spent by the IRS, practitioners and employers dealing with the enactment of Code Section 409A, we can only hope that Congress is careful when writing changes to the tax code related to nonqualified deferred compensation.

Performance-based compensation (including compensation from stock options and stock appreciation rights) would no longer qualify for exemption from the $1 million annual limit on deducting compensation for "covered employees". CFO's would once again become subject to the Code Section 162(m) limit. Finally, once an individual is labeled a covered employee, all compensation paid to that individual would be subject to the annual limit. It doesn't matter if you subsequently stop being an active Named Executive Officer. (Under current law, compensation paid after you terminate employment is effectively exempt from Code Section162(m).) This would take effect after 2014. As a matter of tax reform policy, some may question why this effort should be restricted to public companies or why it should be restricted to the five individuals named in a company's proxy filing. Recently enacted Code Section 162(m)(6) is an example of how Congress could extend the reach of the $1 million deduction limit to a broader group of individuals. Also, the next item illustrates how tax-exempt organizations would face a comparable economic burden for paying executive compensation above $1 million.

A tax-exempt organization would be subject to a 25% excise tax on compensation in excess of $1 million paid to any of its five highest paid employees for the tax year. The excise tax also would apply to "excess parachute payments" paid by the organization to such individuals. Under the provision, an excess parachute payment generally would be a payment contingent on the employee's separation from employment with an aggregate present value of three times the employee's base compensation or more. The provision would be effective for tax years beginning after 2014. It is unclear if the excess parachute provision is intended to solely cover severance situations or is intended to cover all benefits triggered upon a termination of employment (e.g., qualified and nonqualified retirement plans). Though one can find examples of questionably high compensation levels in a tax-exempt setting, this proposed provision will certainly spark some debate over whether it should apply to all situations where an individual's compensation in a tax-exempt setting level exceeds $1 million.

Intermediate sanctions (relating to excess benefit transactions between a tax-exempt entity and a disqualified individual) would be extended to apply to athletic coaches and investment advisors. Also, reliance on professional advice, by itself, would not preclude a manager from being subject to the excise tax for participating in an excess-benefit transaction. Minimal due diligence steps, as outlined in the proposal, would need to be performed to avoid getting hit with the 10% excise tax on excess benefit transactions. If this part of the proposal gains traction, be on the lookout for members of Congress who start showing up at the 50 yard line.

The full text of the **entire** discussion draft can be viewed at http://waysandmeans.house.gov/uploadedfiles/ways_and_means_section_by_section_summary_final_022614.pdf

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Aon Hewitt's Technical Insights provides expert perspective into the market forces and trends affecting executive compensation and corporate governance. These periodic reports are intended to cover many of the wide-ranging issues that compensation practitioners face when designing and administering executive compensation arrangements. For more information contact Dave Sugar at (847) 442-3477 dave.sugar@aonhewitt.com.