Center On Executive Compensation

November 11, 2017

The Honorable Orrin Hatch
Chairman
Senate Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington, DC 20510

RE: Center On Executive Compensation Comments on Nonqualified Deferred Compensation Provisions of the Chairman's Mark, Tax Cuts and Jobs Act

Dear Chairman Hatch:

On behalf of the Center On Executive Compensation, we appreciate your leadership on tax reform. I am writing to express our concern over two provisions that would make changes to the following tax code sections:

- The substantial revision to the nonqualified deferred compensation provisions of IRS Code 409A; and
- The repeal of the "Performance-Based Pay" exception to Section 162(m).

We recognize that tax reform will create the need for significant trade-offs between tax code changes designed to spur long-term economic growth and the need to offset the revenue lost by those provisions. However, with respect to the two sections, we are especially concerned with the expansion of the definition of nonqualified deferred compensation and of taxing stock options and SARS as of the vesting date. The changes will:

- Eliminate approaches that allow a broad array of employees to restore retirement benefits due to income limits, without the security of qualified savings;
- Virtually eliminate incentive vehicles that have effectively aligned compensation with shareholder interests, particularly for start-ups and emerging growth companies; and
- Create an unprecedented tax structure where an individual will be taxed on income the individual has not received – and may never receive – because income from options is not actually received until the options are exercised.

It is worth noting that because of the problems this language would create, the House Ways & Means Committee removed the provision dealing with nonqualified deferred compensation before reporting its bill out of committee this week.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the chief human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 370 large companies that employ over 9 percent of the U.S. private Sector workforce, and the Center's Subscribers represent a broad cross-section of industries.

<u>Repeal of IRS Code Section 409A and Replacement with New Code Section 409B</u>

<u>Background on Nonqualified Deferred Compensation</u>. Section 409A provides a framework for nonqualified deferred compensation that requires certain approaches to deferred payments be followed or the deferrals will trigger current taxation and a 20 percent excise tax as well as penalties and interest. The primary requirements of section 409A is that an employee must elect to defer the compensation in the year before the compensation is received (*i.e.*, there must be a "substantial risk of forfeiture") and distributions can only be made under six special circumstances. Nonqualified deferred compensation and 409A compliance is notoriously complex and was substantially narrowed following the Enron scandal in which executives withdrew nonqualified deferred compensation as the company collapsed.

Nonqualified deferred compensation allows companies to restore benefits to a broad array of employees—*not just highly compensated executives*—who are affected by the income limits of qualified plans, and it encourages both personal and retirement savings by employees. However, in contrast to benefits through tax qualified retirement plans, nonqualified deferred compensation is pay at risk—if the company is insolvent or bankrupt, individuals lose the amounts deferred—and therefore the arrangement incentivizes strong operating performance. This serves as a useful compensation tool for companies, especially as equity-based compensation has taken the place of retirement plans. Nonqualified deferred compensation also provides for a "matching principle" – compensation is not taxed until it is received by the individual. It allows companies to delay payment to the individuals, thus preserving the use of cash for other purposes, such as investment. Thus, it is dubious that prohibiting deferrals will generate significant revenue, given that where deferrals are not used, companies will be able to deduct compensation in the year paid and the individual pay the taxes.

<u>Chairman's Mark Will Substantially Reduce, If Not Eliminate Options, SARs</u>. The Center's chief concern with Section 3802 of the bill is that in the revised 409B and more specifically, the provision which provides for the taxation of all equity on *vesting* and the resulting impact on the treatment of stock options and stock appreciation rights. Stock options and stock appreciation rights are fundamentally different than other forms of equity awards, such as restricted stock, that provide a full value share of stock or a unit representing a share of stock). Stock options and SARs help align compensation with shareholder interests, as individuals only realize compensation if shareholders do not experience an increase in their investment. Even then, individuals do not realize compensation until the options or appreciation rights are exercised, even if they are "in the money." In addition to serving as an effective alignment tool for all companies, stock options, because of how they work, provide companies with a uniquely effective incentive tool when companies are new (*i.e*. startups and emerging growth companies, which heavily rely on options to retain key talent before entities become profitable). The effect of taxing options and appreciation rights at the vesting date will be that most companies will stop using them altogether, depriving companies of a highly effective compensation tool that is typically one element of a long-term incentive structure.

A stock option provides an individual with a right to purchase a share of stock at the "strike price" – typically the stock price on the date the options are granted. An individual can only realize any value from the stock option by "exercising" the option when the value of the company's stock is above the value of the "strike price". The value of the individual's income is the difference between "exercise price" and the "strike price". If the value of the stock on the date of exercise does not exceed the value of the "strike price", then an individual will not realize any actual income and the options are "under water" – the individual would pay more for the share by exercising the option than the shares are worth on the public market creating an economic loss. As a retention tool, stock options typically vest over a three or four-year period, and after the vesting date, recipients are able to exercise the option or SAR, realizing compensation in the form of cash or stock.

As written, 409B creates an inconsistent and untenable taxation scenario for stock options and SARs which separates the concept of matching income and taxation, and thus would largely render options unusable as vehicles for alignment of compensation with shareholder interests. Here are three examples of how 409B creates tax inconsistencies:

- **Example #1 – "In the Money" Stock Options** – If stock options are taxed at vesting as proposed, the IRS would presumably value the income by using the intrinsic value of the option (the "strike price" multiplied by the number of shares vesting). Assume, for example, that an individual is granted 10 options with a 10-year term that all vest after three years at a strike price of $10, and after three years, the stock price has appreciated to $15 per share, the individual would presumably be taxed on income of $50 ($5 per share appreciation x 10 shares). However, because the individual has not exercised the options, there would be no actual income.

  The individual would also be taxed yearly for any incremental increase in stock price during that year over the stock price at the vesting date (so-called "mark-to-market taxation.") For example, suppose further that the value of the stock goes up to $1 each year in years four, five, six seven and eight and exercises the options in year eight. The individual would be taxed $10 each year (10 options x $1 each).[1]

- **Example #2 – "Underwater" Stock Options** – Alternatively, suppose the value of the stock declines to $5 a share at the end of year 9. The market value of the options is less than the exercise price and the options are without value (*i.e.*, "underwater") at expiration. The individual would have paid $50 in tax in year 3 on 10 shares of stock that he or she does not own.[2]

- **Example #3 – Stock Appreciation Rights** – For the purposes of taxation, function virtually identical and create the same set of inconsistencies due to the changes in new 409B. The only difference is that stock appreciation rights only give individuals the right to the value of appreciation between the market price and the strike price.

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[1] This scenario provides a great example of why startups rely so heavily on options. Key individuals can be provided with options to purchase stock at a low price that will appreciate if the company is successful. The incentive to stay with the company because of the potential increase in the value of stock options is an extremely effective retention tool.

[2] It is worth noting that if a value of a company's stock falls below the strike price the options are – "under water" – and no one would exercise them as to do so would essentially be deliberately losing money.

Given the two scenarios and the significant impact that the changes would have on the use of commonly used forms of equity compensation, the Center recommends that the section be struck in its entirety. Alternatively, the Center urges that 409B be re-drafted to provide for an appropriate taxation strategy which accounts for how U.S. listed public companies make use of equity compensation, especially stock options and SARs which should be taxed based on the value at exercise.

<u>Nonqualified Deferred Compensation Provisions Subjects Performance-Based Equity at That Vests at Retirement to Immediate Taxation</u> –A similar problem occurs when a company grants performance-based restricted stock units (RSUs) to individuals that provide for accelerated vesting when the individual hits retirement age. The value of the equity award is not determinable until the performance-period ends, and typically, the individuals continue working and are still subject to the terms of the plan. In such a scenario, upon reaching retirement age, the performance-based RSUs vest in full and thus, under new 409B, would be subject to immediate income taxation (although the amount of income to be recognized is unclear based on the provisions of the bill). However, although the individual's shares have vested, they are otherwise still subject to the terms of the RSU plan and will not gain actual receipt of the shares until the performance period ends. When that occurs, the individual receives full ownership of a set number of shares based upon the level of performance. Under Section 409B as drafted:

- If the performance level at the end of the performance period is below the value calculated at the vesting date, the individual will have paid more in taxes than the income realized from the award;
- If the performance level at the end of the performance period is higher than the calculated value at the vesting date, the individual receives a net tax benefit, resulting in less tax paid to the Treasury than income received.

One point is certain – it will be extremely rare when the amount of tax paid will match the income realized upon performance.

<u>Repeal of the Performance-Based Pay Exception to Internal Revenue Code Section 162(m)</u>

Section 162(m) of the Code permits companies to deduct compensation amounts paid to a company's CEO and three other most highly paid executives in amounts exceeding $1 million so long as the compensation is performance-based. Section 162(m) also provides that stock options are considered *per se* performance-based. Executive compensation programs for the nation's top employers have long made use of this provision and are structured in a way which ties compensation to corporate performance. The pay-for-performance structure of these executive compensation arrangements not only assists in aligning the interests of management with those of the shareholders but also to align with the requirements of Section 162(m).

We recognize that the debate over executive compensation and the increase in pay levels is often associated with 162(m). However, employee compensation, including executive compensation, has historically been a deductible business expense, and the experience of section 162(m) has shown that rather than reduce executive compensation, it has created a de facto floor for CEO salaries. The performance-based exception has been one way to encourage the alignment of pay and performance, and repeal of that exception may cause more companies to pay compensation in forms not directly to performance. It would also create greater inconsistencies in the tax code between senior executives and other employee levels in the company. Other requirements have had a greater impact on CEO pay design, including a now mandatory vote on executive compensation at all public companies which has resulted in significant dialogue on the issue and many internal changes to corporate pay practices.

For these reasons, although we strongly support the objectives of tax reform, we urge you to consider adjustments, especially to the nonqualified deferred compensation sections of the Tax Cuts and Jobs Act. If you have any questions, please contact me at tbartl@execcomp.org or Henry Eickelberg at Heickelberg@execcomp.org. Thank you for your consideration.

Sincerely,

Timothy J. Bartl

Timothy J. Bartl
President and Chief Executive Officer

cc: Members of the Senate Finance Committee