The ERISA Industry Committee

Driven By and For Large Employers

1400 L Street, NW, Suite 350, Washington, DC 20005 • (202) 789-1400 • www.eric.org

Annette Guarisco Fildes, President & CEO

November 14, 2017

The Honorable Orrin Hatch
Chairman, Senate Finance Committee
219 Dirksen Senate Office Building
Washington, DC 20501

Re: Disastrous Retroactive Changes to Employee, Director, and Independent Contractor Compensation

Dear Chairman Hatch,

The ERISA Industry Committee ("ERIC") has outlined below the negative effect of the sweeping changes proposed in the pending tax bill on the taxation and deduction of employee, director, and independent contractor compensation. As explained below, this bill upends the tax treatment for workers and companies not just of traditional deferred compensation, but also of all stock options, long-term performance bonuses, severance pay, and many types of employee fringe benefits. Importantly, many of these provisions that are effectively retroactive could subject this legislation to challenge as an "ex-post-facto law," prohibited by Article I, Section 9 of the U.S. Constitution.[1]

ERIC is the only national association that advocates exclusively for large employers on health, retirement, and compensation public policies at the federal, state, and local levels. ERIC members provide comprehensive health, retirement, and compensation benefits to tens of millions of active and retired workers and their families, providing them with income security and wellbeing. ERIC members have a strong interest in policies that affect our member's abilities to offer competitive compensation packages to their employees and their families.

I. Accelerated Income Taxation of Deferred Compensation[2]

A. Immediate Taxation of Not-Yet-Realized Compensation for Post-2017 Services.

The bill proposed for markup by the Senate Finance Committee would tax workers on all compensation attributable to services performed after 2017 (including stock options and severance pay) as soon as all the

[1] Article I, Section 9 of the Constitution provides, in part, that "No bill of attainder or ex post facto law shall be passed." An ex post facto law is defined as one that retroactively alters a person's rights "especially by criminalizing and imposing punishment for an act that was not criminal or punishable at the time it was committed, by increasing the severity of a crime from its level at the time the crime was committed, by increasing the punishment for a crime from the punishment imposed at the time the crime was committed, or by taking away from the protections (as evidentiary protection) afforded the defendant by the law as it existed when the act was committed." Grandfather protections are added to tax bills (and should be added to H.R. 1) to avoid violating this rule.

[2] The House version of the bill (proposed as Section 3801 of H.R. 1) has already dropped the proposed changes accelerating taxes on deferred compensation, but the Senate bill (as described at pages 116-124 of the Senate Finance Committee Report, JCX 51-17) includes all the provisions discussed below.

"substantial services" have been performed by the worker that generate this future compensation, with the creation of a new Internal Revenue Code Section 409B. Income taxes apply even if the employee does not have a truly vested right to the compensation, or does not know the amount of the future compensation. No income-inclusion delays are allowed for performance conditions (e.g., unpaid bonuses linked to company performance, or stock option compensation linked to the company's stock price). Similarly, no income-inclusion delays are allowed for unpaid amounts subject to non-competition agreements (whereby the worker agrees not to compete after termination of service). Arguably, severance payments (including change-in-control payments) would be taxed before the employee severs, or before the company changed control. No guidance is provided on how to compute these impossible-to-determine future payments – the bill simply arbitrarily taxes the "compensation." The only exceptions from this tax-at-vesting rule are for amounts payable within 2.5 months after the end of the year when the services are performed (such as short-term performance bonuses), for payments that are "bona fide vacation leave, sick leave, compensatory time, disability pay or death benefits," for tax-qualified stock options (ISOs and ESPP plans[3]), and for payments of "restricted property" (i.e., property covered by Code section 83, or amounts place in a trust protected from claims of company creditors).

The compensation made taxable by this bill in most cases would not yet be distributed. Thus, income and FICA taxes would be owed by the workers even before the funds have been paid. Also, this compensation, even though it is included in workers' incomes, is not deductible by the company until it is actually paid (and, when paid, may be subject to the new deduction-limitations discussed below). Thus, for example, employees would be taxed on long-term performance bonuses before the end of the performance period, would be taxed on stock options as soon as they are vested (long before the end of the option period[4]), and would be taxed on severance before they are severed. The bill does not even include a rule to permit the early distribution of funds that would be needed to pay taxes. And, if these monies are never paid (because performance criteria are not met), the employees would not be entitled to an offsetting future deduction to recoup the taxes they paid on the never-received income.

B. <u>Taxation in 2026 of all Pre-2018 Deferred Compensation (i.e., 2026 Income Taxation Also Prior to Income Realization)</u>.

All deferred compensation attributable to services performed before 2018 (including amounts deferred before 2004 that were eligible for grandfather protections under Code section 409A), would be taxable in 2026. (An exception applies only if the amounts were distributed before that date, in compliance with the complicated rules of Section 409A, governing deferral elections and distribution timing.) The provisions of Code section 409A would not be repealed until 2026, and thus any attempts to accelerate prior compensation deferrals would not be permitted.[5] Instead, all the deferred compensation taxable in 2026 would be taxable in 2026 at the worker's highest marginal tax rate then in effect. Also, while the tax bill would allow amounts to be paid out to employees who are subject to withholding, to enable them to pay the income taxes triggered by this provision, the actual distributions of the rest of this pre-2017 deferred compensation could be distributed only under "regulations to be

[3] The House bill also created a new type of "qualified stock" for private companies, that would also have been excepted from these compensation-acceleration rules.

[4] If stock options are taxed on their "value" at vesting, they might even be taxed at a time when the options are "underwater" – i.e., when the option's price for the stock is less than the stock's value.

[5] The effective date of the repeal of Code section 409A was not stated in the initially proposed (but quickly abandoned) provision in the House Bill. That House bill provision had required the income taxation of all pre-2018 deferred compensation in 2025, and the accompanying committee report indicated that "The current-law rules would continue to apply to existing non-qualified deferred compensation arrangements until the last tax year beginning before 2026, when such arrangements would become subject to the provision." *See* the Committee on Ways & Meals Section-by-Section Summary of H.R. 1, at page 55-56. The Senate Finance Committee Report (JCX-51-17) explains that the proposed income-inclusion date for all pre-2018 deferred compensation is 2026 (instead of 20205, as in the House bill), but it did not mention the repeal of Code section 409A, or state any effective date of such a repeal.

issued after enactment." Thus, potentially, the government gets the money, and the employee is left only with the promise of future payments.

Importantly, this legislation also triggers state and local income taxes on most of these accelerated income-recognition events for pre-2018 deferred compensation because the income made arbitrarily taxable in 2026 would automatically be ineligible for the state/local tax exemption applicable under 4 U.S.C. §114, the provision enacted in 1997, to ensure that state and local taxes can be imposed only by the residence state of employees who are receiving distributions of deferred salaries and bonuses over at least a 10-year period.[6] Thus, in 2026, when employees are taxed on all of their pre-2018 deferred compensation, they will be subjected to state and local income taxes by all the states and localities where the employees worked when that compensation was earned (at any point during the years - possibly more than 50 years) before the compensation became taxable). Under separate provisions of the tax bill, these state and local taxes imposed in 2026 on compensation earned many years in the past would not be deductible, either.

As was true with the tax-at-vesting rules for post-2017 compensation, companies could claim deductions for this compensation only when the funds are actually paid out. Also, even if the pre-2017 deferred compensation is paid in 2026, the deduction for fiscal year companies would be delayed until the company's year that includes December 31, 2026.[7] Thus, while these income-acceleration and deduction-delay provisions may help the revenue score for this bill (i.e., income inclusion for workers in the 10-year budget period, while the companies' tax returns claiming any deductions are not filed until after the end of the 10-year budget period), this is only a cash-flow and accounting trick, not defensible tax policy.

II. Enormous Expansion of Deduction Disallowance Rules for Compensation over $1M to any Top Executive of a Corporation with Publicly Traded Stock or Bonds.

As if the above-described income accelerations were not bad enough, the tax bill (both House and Senate versions) also massively expands the deduction-disallowance rules of Code section 162(m) (which since 1993 has limited deductions for certain compensation to the CEO and top three proxy-listed executives, defined as "covered employees" of publicly traded corporations).[8] Basically, these changes methodically eliminate every single exemption from these deduction-disallowance rules that has ever been provided by the prior statute, regulations, and hundreds of IRS private letter rulings. This provision:

1. Eliminates the performance-pay exception (so all performance bonuses, all stock options, and all SARs are non-deductible if the employee's total compensation in a year, including these amounts, exceeds $1M).[9]

2. The CFO becomes a "covered employee,"[10] whose compensation over $1M is not deductible.

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[6] Distributions under so-called "excess plans" would still be protected under 4. U.S.C. § 114.

[7] Code section 404(a)(11) allows a deduction for deferred compensation only when it is paid. Further Code section 404(b) and Treas. Reg. 1.404(b)-1T allows a deduction, even for payments, only in the payor's year that includes December 31 of the income-inclusion year.

[8] A new 20% excise tax applies to top employees of tax exempt organizations who earn over $1M.

[9] Performance compensation (including bonuses and stock options) have been exempted from Code section 162(m), by the statute and regulations.

[10] CFOs were excluded from the group of "covered employees" by Notice 2007-49, 2007-25 I.R.B. 25.

3. Any person who is a "covered employee," in 2017 or later years remains a "covered employee" forever, even after service termination, or after divorce or death (when ex-spouses and beneficiaries get the payments). Thus, there will be dozens, and eventually hundreds, of current and future executives in each company who will be treated as "covered employees." And, for any of these employees receiving compensation exceeding $1M in any year, deductions will be denied to the company for all such compensation, (including compensation relating to (a) performance bonuses, (b) stock options; (c) pre-1994 grandfathered compensation, (d) compensation paid to executives of acquired corporations; and (e) pre-IPO compensation paid over 3 years after the IPO) – even though all these compensation items were exempted from section 162(m) under prior law.[11] Most certainly the deferred compensation over $1M per covered employee that becomes taxable in 2026 (under the income-acceleration rules described above) will not be deductible– even though the company, in good faith and in reliance on pre-2018 tax law, had structured its compensation agreements so as to preserve its deduction.

4. Eliminates the exemption for foreign companies with stock traded on non-U.S. exchanges that have debt traded on U.S. exchanges.[12]

The revenue estimate for this provision is "$9.3 billion over 10 years" under the House estimates, and "$10.4 billion over 10 years," in the Senate estimates. Much of this revenue would be raised, however, only due to the retroactive elimination of exemptions that have been relied on for years by companies that have structured their compensation plans so as to comply with these provisions.

III. Expansion of Deduction-Disallowance Rules for Employee Fringe Benefits.

The tax bill also proposes to eliminate many long-standing income exemptions (including the exemptions for moving expenses, non-job-related educational assistance[13]). But, the changes are even more harmful to companies providing fringe benefits, because deductions are disallowed for an even broader range of benefits. These proposed disallowance rules would apply to two types of benefits. First, they apply to many benefits that continue to be excludable from income (like all entertainment benefits, including business-related entertainment, parking, mass transit, van pooling and on-premises gymnasiums). Second, these proposed deduction-disallowances apply to benefits that are taxable but subject to special valuation rules (like airplanes, certain company cafeterias, dependent care facilities and tax-preparation expenses for global travelers). Companies have bought aircraft, and have constructed day-care facilities, cafeterias, gymnasiums, and parking facilities, all in reliance on prior law (which allowed deductions or all these expenditures), are suddenly facing deduction-disallowances for the continuing costs (and for previously unclaimed depreciation) for facilities and contracts in place as of November 2, 2017.

IV. Why These Provisions Should Be Changed.

Company employees and directors, in good faith and in reliance on existing tax law, have deferred compensation for prior services, and planned when and where they will retire, with the expectation that they would not be taxed

[11] The statute, regulations, and dozens of private letters rulings have confirmed that compensation paid after an executive terminates service as an executive or after any corporate acquisition is exempt from 162(m). The regulations also provided grandfather rules for pre-1994 compensation, and for certain compensation paid (or options and SARs granted) during the 3 years after an IPO, but the new section 162(m) provisions eliminates all these exemptions, excepting the ones covering the 3 years after the IPO.

[12] This exemption was provided in several IRS private letter rulings.

[13] The House bill, but not the Senate bill, also eliminates the exclusion for achievement awards, adoption assistance and (after 2022) dependent care.

on such income until they retired or left the company. Companies have structured stock options and bonus plans for their top executives (and also agreed to deferrals of prior-service compensation), and have built or bought facilities for gymnasiums, cafeterias, parking and transportation, all in good faith reliance on existing tax law, which allowed deductions for all of these types of compensation and all these fringe benefit facilities. Under the tax bill, all these compensation deferrals are taxable, and many of the corporate deductions are permanently disallowed. It is not simply "unfair" to adopt these dramatic changes in the law (as poorly designed and badly explained revenue-raisers), it is arguably illegal (under the prohibition on ex post facto laws contained in the Constitution).

V. What Must Be Changed

If any of the above-described provisions are retained in the pending tax bill, changes should be added to protect existing arrangements, and to provide transition rules. We recommend the following changes:

A. Changes to Deferred Compensation Provisions.

- Add grandfather protections for all deferred compensation earned after 2017 that is payable under agreements in place as of November 2, 2017.[14]

- Drop taxation at vesting of stock options and SARs (or, at a minimum, ensure that the options are not taxed on more than the option spread at vesting - i.e., no Black Scholes method could be applied to value the options).

- If the harsh income-acceleration rules are retained, clarify that the deferred compensation is taxed only once (matching the FICA tax rules that tax deferred compensation on vesting, and do not impose FICA taxes on subsequent earnings).

- If the harsh compensation-acceleration provisions are retained, allow workers a future deduction if performance conditions are not met, if bonuses are not paid, if employees never sever, if changes in control do not occur, if the option/SARs are not worth (at exercise) the amounts previously taxed, or if the employer goes bankrupt or is otherwise unable to pay the deferred compensation.

- If the harsh compensation-acceleration conditions are retained, adopt withholding rules that allow companies to tax any taxed but non-distributed compensation as late as the end of the calendar year (matching the non-cash fringe benefit rules under Code section 3501(b), and the FICA tax rules under Code section 3121(v)(2) that apply a "rule of convenience" that allows delay of taxation until year-end). This avoids huge complications for awards that may vest employees on a monthly basis, on awards that have not been paid yet (due to performance conditions on bonus awards, or, for stock options, because the option has not been exercised).

- Add rules permitting payout of at least enough funds to cover income and FICA taxes (with a gross-up) on the payouts of post-2017 deferrals (since no such rules are included in the bill).

- Add transition rules permitting accelerated payout before 2026 of amounts subject to Section 409A (in order not to tax all the funds at once).

[14] At a minimum, grandfather protections are needed for agreements that vested in any part before 2018. Otherwise, participants in long-term performance bonus plans, or persons holding previously granted stock options and SARs would be taxable on undeterminable portions of these awards.

- Ensure continued application of the state tax blocker in 4 U.S.C. §114 (through an amendment to proposed Code section 409B) to cover past and/or future deferred compensation payments made taxable under the compensation-acceleration rules of section 409B.[15]

- Suspend penalties for failing to withhold and/or timely deposit in 2018 for any benefits made taxable by this legislation, or for any errors in withholding made as a result of the bill's separate changes to the standard deduction and personal exemptions (which will require changes in Forms W-4 for every worker in the U.S.).

B. Changes to Section 162(m) Deduction Limitation Provisions.

- Add grandfather rules for all compensation payable under a written binding contract which was in effect on or before November 2, 2017, and which is not modified thereafter in any material respect before such remuneration is paid (disregarding for this purpose any change to defer or accelerate the distribution of such compensation).

C. Changes to Fringe Benefit Deduction Limitation Provisions.

- Add grandfather rules for all facilities for parking, cafeterias, gymnasiums, or transportation (or contracts to buy, lease or build such facilities) in place as of November 2, 2017.

- Adopt withholding transition rules for all cash reimbursements for fringe benefits made taxable by the bill (like moving expense and educational assistance reimbursements) similar to rules for non-cash fringes under Code section 3501(b)).

- Suspend penalties for failing to withhold and/or timely deposit in 2018 for any benefits made taxable by this legislation (or for any withholding errors attributable to the changes made in the standard deduction and personal exemptions, which will require collection of new Forms W-4 from every employee (and former employee) paid wages in 2018).

All of these above-listed transition rules are needed, both in the interest of fair tax administration, and also to prevent "ex-post-facto law" challenges to this legislation.

[15] This change ensuring continued protection from state and local taxes or payments of deferred compensation to nonresidents could be made simply by adding a provision to proposed Code section 409B, to state:

> "Any payments (or inclusions in income) of deferred compensation (as defined in 26 U.S. C. § 409B(b)(2) through (4)) that occur between January 1, 2018 and December 31, 2026, that are attributable to services before, on or after December 31, 2017 and that are either includible in income under 26 U.S.C. §409B(a), or are paid to comply with the payment deadline of 26 U.S. C. §409B(d) are deemed to be " retirement income" as defined in 4 U.S.C. §114(b), and are exempted from state or local tax under that section if paid to any individual who spends 183 days (or more) as a resident or domiciliary of another state in the year the retirement income is paid (or included in income)."

This change would have no effect on the revenue estimates for this bill.

We would be happy to meet or speak to you about any part of this letter. Thank you for your consideration on these important matters.

Sincerely,

Annette Guarisco Fildes

Annette Guarisco Fildes
President & CEO