MERIDIAN
COMPENSATION PARTNERS, LLC

VOLUME 5, ISSUE 6
MARCH 27, 2014

Meridian Client Update

Proposed Tax Reform Potentially Impacts Executive Compensation

In late February, the Chairman of the House Ways and Means Committee (Dave Camp (R-MI)) released a comprehensive draft proposal to reform the Internal Revenue Code. These reforms would tax deferred compensation upon vesting and would eliminate the performance-based exception under IRC Section 162(m).

Nonqualified Deferred Compensation

Current law: Under current law, compensation generally is taxable to an employee and deductible by an employer in the year earned, regardless of when the compensation is received by the employee. However, in the case of nonqualified deferred compensation, an employee does not recognize taxable income until the year the deferred compensation received (assuming that all applicable requirements, including under Section 409A of the Internal Revenue Code have been met) and the employer's corresponding deduction is postponed until that time. The date on which such compensation is no longer subject to a substantial risk of forfeiture does not impact the timing of income inclusion.

Proposed law: Under the proposed legislation, an employee would be taxed on deferred compensation as soon as such compensation is no longer subject to a substantial risk of forfeiture (i.e., receipt of the compensation is not subject to **future** performance of substantial services). The proposed legislation would apply to amounts attributable to services performed after December 31, 2014. Current law rules (including Section 409A) would continue to apply to compensation deferred prior 2015. Such deferred compensation would become subject to the proposed law in 2023 meaning that the compensation would be includible in income the later of (i) the year of vesting or (ii) 2022.

Meridian Comment. *The proposed law would effectively eliminate many forms of traditional deferred compensation and adversely impact other forms. For example, an employee's election to defer receipt of salary would no longer result in the deferral of taxation since deferred salary is rarely subject to a substantial risk of forfeiture. The same would be true with respect to an employee's deferral of an annual bonus or long-term cash incentive, unless such deferred compensation was subject to a substantial risk of forfeiture.*

The proposed law would also undermine the benefits derived from non-contributory nonqualified deferred compensation arrangements, such as SERPs or restoration plans. Among these benefits is the deferral of taxation on amounts accrued and any earning thereon until such amounts are distributed to the employee. Under the proposed law, upon ***vesting*** *these amounts would become subject to federal income tax.*

It remains to be seen whether this proposed bill will get any traction in Congress. However, organizations should consider reviewing the status of current deferred compensation policies.

Compensation Paid in Excess of $1 Million to Executive Officers

Current law: Under current law, the deduction for compensation paid or accrued with respect to a "covered employee" of a publicly traded corporation is limited to no more than $1 million per year. The deduction limitation applies to all remuneration paid to a covered employee for services except for (1) commissions; (2) performance-based compensation, including stock options; (3) contributions to or payments from a tax-qualified retirement plan; and (4) amounts that are excludable from the executive's gross income. Covered employee is defined as the chief executive officer and the three highest-paid executive officers, other than the CEO and chief financial officer, who are employed on the last day of the company's tax year and reported in the company's proxy. Chief financial officers are not treated as covered employees.

Proposed law: Under the proposed law, the current exceptions to the $1 million deduction limitation for commissions and performance-based compensation would be repealed. The provision also would expand the definition of "covered employee" to include a public company's chief financial officer. In addition, once an employee of a public company qualifies as a covered employee, the $1 million deduction limitation would apply to that employee during his remaining employment with the public company. The proposed law would be effective for tax years beginning after 2014.

Meridian comment. *The proposed law continues Congress's ongoing efforts to limit the deductibility of compensation paid to top executives. As we previously reported (see Client Update 2014-3), other bills are pending in the House and Senate that would sharply curtail the deduction a public company may take for compensation paid to proxy-disclosed officers in excess of $1 million under Section 162(m).*

While the draft bill is unlikely to move forward in the current Congress, it may provide potential insights into Republican positions on tax reform during the Congressional elections this year and the presidential election in 2016.

* * * * *

The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

www.meridiancp.com