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Special Edition

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Section 3801 of the Tax Cuts and Jobs Act

This report provides K&L Gates' initial executive summary of Section 3801 of the Tax Cuts and Jobs Act, which would virtually eliminate the NQDC market and have broad impacts on a number of common compensation arrangements across our economy.

Section 3801

Section 3801 of the Tax Cuts and Jobs Act created a new section, **Internal Revenue Code §409B,** which:

- Eliminates ability to defer compensation for all U.S.-taxpayer employees and other service providers (directors and consultants) at all levels of for-profit businesses—start-ups, private companies, public companies, etc.
    - Applies to all levels of service providers, not just high-paid executives
- Requires income to be recognized when compensation is no longer subject to a "substantial risk of forfeiture" (SRF), with a narrow definition of SRF:
    - SRF can be based only on requirement to provide substantial future services
    - Specially excludes SRF based on performance conditions (as otherwise permitted under IRC §83 and §409A)
    - Specifically excludes SRF based on compliance with a non-compete (as otherwise permitted under IRC §83)
- Broadly defines "nonqualified deferred compensation" (NQDC) to include any amounts that could be paid later than March 15 of the year after the year the SRF lapses, with explicit exceptions for qualified retirement plans, certain welfare benefit plans (e.g., vacation and disability), and transfers of property (excluding options) subject to IRC §83, and specifically includes as NQDC:
    - stock options and stock appreciation rights
    - restricted stock units and other forms of phantom equity
- Applies to all compensation earned for services beginning January 1, 2018 (immediate)—requires end of all pre-2018 deferrals by end of 2025

§409B Would Adversely Impact U.S. Businesses, Employees, and Shareholders

The following lists some of the potential adverse consequences of §409B:

- U.S. businesses will be less competitive globally because of the limited flexibility to compensate employees as compared to the majority of industrialized nations.
- Millions of U.S. employees—not just top-paid, public-company executives—may experience (1) lower pay due to reduced equity and performance-based incentive opportunities, (2) reduced retirement benefits, and (3) higher taxes due to lost deferral opportunities.
- U.S. businesses will find it significantly more difficult to align employee pay and long-term shareholder interests, which will harm shareholders, businesses, and employees.
    - Employees' ability to share in the long-term success of their employers will be severely limited.
    - Employees will be incentivized to focus on short-term performance at the expense of long-term performance.
    - Compensation techniques for discouraging excessive risk-taking will be significantly limited.

§409B Would Effectively Eliminate Many Common Compensation Practices

The following widespread and long-standing forms of compensation would effectively be eliminated or dramatically curtailed by §409B:

- Stock options (potentially including tax-qualified IRC §422 "incentive stock options")
- Employee stock purchase plans (ESPPs) (potentially including tax-qualified IRC §423 ESPPs)

- Multi-year performance bonus plans that provide employees with share in the growth and financial success of the employer
- Compensation holdback policies designed to reduce excessive risk-taking practices
- Stock-based awards designed to provide income protection at death, disability, or retirement and align to shareholder interests through retirement
- Severance arrangements intended to give income security to terminated employees for periods longer than 3 months
- Retirement plans which provide retirement security at companies when 401(k) plans are not available or contribution limits are constrained
- Other forms of retirement programs intended to make up for IRC limitations or provide long-term retention and incentives

Many of these practices are especially common among small and private businesses, where the potential for growth and innovation is high but cash-flow and liquidity are constrained. These practices are also broad-based and allow employees outside of executive management to share in the upside of a growing company and save for retirement.

Additional Details on Adverse Impacts and Unintended Consequences

- ***Stock Options and Phantom Equity*****.** §409B would effectively eliminate the use of stock options, stock appreciation rights, and phantom equity (including RSUs) for all U.S. businesses. Stock options, in particular, are a foundational form of incentive compensation for businesses at all levels, in part because they are simple in concept, well understood, effectively align interests of employees with shareholders, and provide rewards only for actual value creation for shareholders. Forcing employees into §83 restricted stock awards as the only form of permitted equity compensation will be impractical for many start-ups/private companies/small businesses because it requires liquidity to pay taxes before the shares are liquid and when the companies need to preserve cash for growth. This will also be a global competitive disadvantage for U.S. business, as most industrialized economies in the E.U., Asia, and elsewhere recognize stock options as an appropriate form of incentive compensation.

- ***Statutory Options (ISOs and ESPPs).*** §409B would eliminate tax-favored forms of equity compensation—incentive stock options (per IRC §422) and employee stock purchase plans (per IRC §423)—intended to encourage broad-based employee ownership in businesses. These are broadly used programs both among public and private companies.
- ***Performance-Based Compensation.*** §409B would severely restrict both public and private companies in designing and implementing long-term, performance-based compensation plans (cash- and equity-based). It is commonplace in such plans to provide an opportunity for an employee to continue to vest in an award, subject to the ultimate performance outcomes, in case of certain terminations of employment, such as death, disability, or termination by the company without cause. §409B would apparently trigger tax at termination of employment (although it is unclear as to how the amount would be determined when performance has not been completed), which will severely hamstring design flexibility or eliminate the programs altogether. Such programs are broadly used both in private companies (typically as long-term cash awards) and public companies, where institutional shareholders strongly urge companies to adopt these types of programs as in the best interest of long-term shareholders. The programs are used with all levels of key employees, sales people, etc.—not just executives.
- ***401(k) Restoration Plans.*** IRC limits on 401(k) plans can adversely impact retirement savings for employees earning as little as $120,000 (the "highly compensated employee" threshold). Smaller companies with blue collar workforces often establish NQDC 401(k) "make-up" plans to permit retirement savings by these impacted employees. §409B will eliminate the ability to use these plans and leave these relatively low-paid "highly compensated employees" with inadequate retirement savings.
- ***Other Retirement Plans.*** Many community banks and privately held businesses use supplemental retirement plans in lieu of equity compensation as a retention and incentive tool for top managers. These plans often provide make-up retirement benefits not available under qualified defined benefit or defined contribution retirement plans because of limits such as the $120,000 highly compensated employee definition or the $270,000 compensation limit. §409B would likely eliminate these plans or force the use of lengthy time-vesting schedules that hurt employees and diminish the retentive value (because employees tend to deeply discount the compensation value of amounts vesting longer than five years). Impacted employees at these companies are not wealthy executives at public companies. For community banks, these programs support

bank regulatory principles by aligning employees with the interests of creditors and depositors in the bank.

- ***Deferral Programs Supporting Risk-Management Practices*.** §409B is directly at odds with the regulatory direction of U.S. and E.U. banking regulators more generally, which have guidelines and rules that push financial institutions to have annual incentive compensation awards deferred for three-to-five-year periods in order to ensure that initial annual performance is sustainable and that risk management policies are observed by risk-takers. The concept of risk-takers goes well beyond executives and top-paid management and can include broad groups of employees in similar incentive plans. These principles have also been more broadly adopted outside of the financial services industry in response to institutional shareholder demands and to ensure that compensation programs properly support risk-management best practices. §409B as proposed would likely require a major re-design of these deferral programs and would likely significantly water down the effectiveness of the programs by forcing tax payments on amounts that would otherwise be subject to forfeiture/clawback for conduct contrary to risk-taking policies or in the event of subsequent financial restatements.
- ***Salary Continuation/Severance*.** As proposed, §409B would apply to routine salary continuation/severance arrangements paying severance over periods as little as three months, forcing companies into lump sum severance payments. This would apply to employees at all levels, not just executives. Salary continuation serves several very reasonable business purposes, including providing companies with a tool to enforce post-employment covenants and to more easily administer post-employment health benefit arrangements by providing a ready source for deducting the employee portion of premiums.
- ***Other Unintended Consequences*.** In the rollout of §409A, one key lesson was that the broad definition of NQDC in §409A (which is less broad than as proposed in §409B) can potentially and unanticipatedly impact a wide range of compensation arrangements impacting all employees, including various types of broad-based employee fringe benefit programs (like various types of service reward programs). Forcing early taxation on these types of programs will dampen innovative compensation design and create additional competitive disadvantages for U.S. businesses as compared to global competitors.

Click Here to Read AALU's Talking Points on NQDC

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