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Nonqualified Deferred Compensation Legislation Would Unnecessarily Restrict the Deferral of Restricted Stock and Restricted Stock Units

Background

Because of recent proposed changes in the accounting for stock options, employers are increasingly awarding employees restricted stock (RS) or restricted stock units (RSUs). Typically, employees are awarded a specified number of RS or RSUs, with a fixed percentage of the RS/RSUs vesting on a quarterly or annual basis or the entire block of RS/RSUs vesting after a specified period of time. Generally, upon vesting of the RS, the employee is entitled to the full ownership of the employer's common stock and is taxable on the fair market value of such stock. Upon vesting of an RSU award, RSUs are converted into shares of the employer's common stock and the employee is taxable on the fair market value of such stock.

The major distinction between RS and RSUs is that the grant of RS typically is treated as an immediate transfer of property for purposes of Internal Revenue Code (Code) sec. 83, while an RSU award is and remains an unfunded, unsecured promise to deliver property (shares) in the future and thus does not constitute a transfer of property under Code sec. 83. Whereas an employee who has been granted RS typically would have dividend and voting rights with respect to such stock, an employee who has been awarded RSUs typically would not have such rights.

In recent years, many companies have amended their RS/RSU programs and/or deferred compensation plans to permit employees to make an advance election (e.g., 6-12 months before vesting) to defer the receipt of shares under the program. The value of the shares at vesting is credited to an unfunded, unsecured deferred compensation bookkeeping account in the employee's name that, for accounting reasons, is typically credited with gains and losses as if it were invested in employer stock. The account is subsequently paid in shares (or, in some cases, cash if elected) and becomes taxable to the employee and deductible to the employer in accordance with the employee's earlier election.

Proposed Legislation

Significant changes to the rules that apply to nonqualified deferred compensation arrangements are pending in Congress as part of House and Senate-passed versions of corporate and international tax reform legislation (H.R. 4520; S. 1637). Among other proposed changes, both the House and Senate versions of the legislation would impose substantial restrictions on the timing of deferral and payment elections. The Senate bill would take a significant step further by amending Code sec. 83 to immediately tax employees on the present value of the right to receive future payments obtained in “exchange” for stock options, restricted stock, employer securities, or any other “property based on employer securities transferred to the taxpayer.”

The Legislation Would Unnecessarily Restrict RS/RSU Deferrals

The Senate proposal to immediately tax employees who make advance elections to exchange rights to receive employer stock in the future for deferred compensation would have the effect of prohibiting the deferral of RS, and might also have the effect of prohibiting the deferral of RSUs. Moreover, both bills would impose substantial and unnecessary new restrictions on the timing of deferral elections generally. The legislation is overly broad and unfair to employees, imposes greater restrictions on employer stock-based compensation than compensation paid in cash, and incorrectly assumes that such transactions are “tax gimmicks.”

- Well-established tax principles allow employees and employers to restructure the form of compensation or time of payment a reasonable time before any amounts are actually payable. Although the underlying nonqualified deferred compensation legislation would impose substantial restrictions on the timing of deferral elections, it would permit such elections with respect to cash compensation under certain circumstances. By contrast, the Senate proposal would impose a complete ban on the deferral of employer stock-based compensation.
- Employees who make these elections give up the future right to receive the stock itself – which they would then be able to dispose of as and when they see fit – for the employer’s unfunded promise to pay the equivalent value (plus credited earnings) at a specified future time. This decision has significant economic non-tax consequences, including the risk that the employee will never receive the deferred amounts (*e.g.*, because of the employer’s insolvency).
- These programs -- which may be broad-based as well as covering higher paid executives -- offer employees a reasonable opportunity to tailor their future compensation to better meet their expected needs and do not involve any “mismatch” or other tax abuse. Whether or not a deferral election is made, the

employee will be taxed – and the company will get a tax deduction – in the same year, i.e., when the amounts are actually paid.

- The Senate proposal could result in punitive taxation of employees even when the employee has not been given any “election” to change an employer stock-based arrangement. For example, there is no exception for changes in the timing of payments as a result of a corporate transaction, employee transfer, or other change imposed by the employer.

Accordingly, (1) the Senate proposal to immediately tax employees who make advance deferral elections of this type should not be included in the final version of the legislation, and (2) both bills should be revised to allow employees to elect to defer income associated with RS and RSUs in the taxable year before vesting occurs.