Nonqualified Deferred Compensation Legislation
Senate Provisions on Stock Option Gain

S. 1637 includes the Joint Committee on Taxation's proposal to prohibit any "exchange" of a stock option for future deferred compensation by making such a transaction immediately taxable.

The provision is overly broad and imposes more restrictive rules on compensation that is paid in the form of stock than compensation that is paid in cash. There is no policy reason to do so.

While Joint Committee appears to have been focussed on stock option exchanges, the legislation is now being interpreted much more broadly . Joint Committee has indicated that this provision could prohibit altogether deferred stock units (DSUs) or restricted stock units (RSUs), which are common forms of equity compensation provided by public companies today. Companies may prefer DSUs and RSUs because they encourage employees to hold employer stock in greater numbers and for longer periods than if actual shares are issued immediately to employees.

Joint Committee staff have stated that this provision is necessary to avoid an "undermining" of Code section 83, which governs the timing of taxation and deductions for compensation paid in the form of property, including employer stock. One of the underlying premises in Code section 83 is that there should be no tax preference between compensation paid in cash versus stock. To the contrary, however, the legislation would impose greater restrictions on stock-based compensation than the legislation is imposing on cash payments.

Under the prevailing interpretation, employees who are awarded the right to receive a future issuance of stock would be taxed currently if there were any changes in the timing of that future award. An employee could have no elections as to the timing of payment. (Contrast the provisions on cash compensation that provide various exceptions.) There is no exception for changes in the timing of payments for corporate events or events beyond the employee's control. There is also no exception for changes in the timing of payouts that are imposed by the employer. It appears that an employer could not make unilateral changes in a stock compensation program (i.e., without any employee "elections") because any change in the timing of payouts would presumably trigger current taxation.