Memorandum

House Tax Bill Would Significantly Alter Executive Compensation

November 3, 2017

Introduction

The recently released Tax Cuts and Jobs Act (the "Bill") could fundamentally change the landscape of executive compensation. If enacted into law in its current state, the Bill would:

- effectively eliminate the tax-deferral benefits of deferred compensation, including arrangements not typically considered deferred compensation, such as severance pay installments, stock options and delayed-delivery RSUs;[1]
- significantly expand the scope of the $1 million deductibility limit under Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), by removing commonly-used exceptions for "performance-based" compensation and increasing the list of executives subject to the law; and
- adding a 20% excise tax on tax-exempt organizations for annual compensation in excess of $1 million and certain severance amounts payable to a tax-exempt organization's senior executives.

House Republicans released the draft Bill on November 2, 2017, and the Bill will be subject to ongoing discussions and negotiations. For a more general description of other non-compensation related changes to the Code as contemplated by the Bill, see our general Client Alert **here**.

Accelerated Tax on Nonqualified Deferred Compensation Arrangements, Stock Options, SARs, and Delayed-Settlement RSUs

The Bill would eliminate tax-deferral benefits under nonqualified deferred compensation arrangements by subjecting all compensatory arrangements to taxation as soon as the compensation is no longer subject to a "substantial risk of forfeiture."

[1] For example, RSUs that vest based on future events such an IPO or a change in control (sometimes referred to as "Facebook-style RSUs" or "private company RSUs") and RSUs that have vesting provisions linked to retirement.

- The Bill narrowly defines "substantial risk of forfeiture" to only include the requirement to provide substantial services. As a result, an employee will be "vested" in the compensation, and therefore taxed, as soon as the employee has provided the necessary services. Subjecting compensation to a future performance condition or delaying payment will not defer taxation. One consequence is that delayed-settlement features in RSUs (including so-called "Facebook-style RSUs" or "private company RSUs" used by many early-stage private companies) would be disregarded and would be fully taxable as soon as they become time-vested.
- The Bill's broad definition of deferred compensation expressly includes stock options and SARs (as well as any other "right to compensation based on the value of, or appreciation in value of, a specified number of equity units of the service recipient, whether paid in cash or equity"). As a result, stock options and SARs would be taxable on vesting. It is not clear whether stock options and SARs would be taxed at the then-applicable "in-the-money" value or at a "Black-Scholes" value or using some other methodology.

If enacted, the new provisions would apply to compensation earned with respect to services performed after 2017. Existing deferrals attributable to services performed before January 1, 2018 would be grandfathered, but would need to be settled or paid before 2026. This proposal regarding nonqualified deferred compensation arrangements largely tracks the rules which currently apply under Section 457A of the Code to deferral arrangements maintained by certain tax-indifferent parties such as corporations based in tax haven jurisdictions or partnerships that are substantially owned by tax exempt entities.

Elimination of "Performance-Based Compensation" Exemption under Section 162(m) and Other Expansions of Section 162(m)

Section 162(m) of the Code currently imposes a $1 million annual limit on deductions for compensation (other than "performance-based compensation") paid to a public corporation's chief executive officer and its next three highest paid executive officers (other than its chief financial officer). Presently, almost every public corporation largely avoids the deduction disallowance under Section 162(m) by structuring annual bonuses, certain equity awards and other incentive arrangements to qualify as "performance-based compensation." The Bill would modify Section 162(m) in several important respects:

- The "performance-based compensation" exemption would be eliminated, meaning that all compensation in excess of $1 million paid to a "covered employee" in any tax year would be non-deductible. This would eliminate the deductibility of employee stock options, annual bonuses, and performance shares for covered employees if their value exceeds the annual limit (together with other compensation).
- The scope of Section 162(m) would be expanded to include the corporation's chief financial officer and any interim chief executive officer or chief financial officer (even if no longer serving at year-end).

- Any individual who becomes a "covered employee" in 2017 or later years would continue to be treated as a "covered employee" subject to Section 162(m) for so long as the individual continues to receive compensation from the corporation, even if the individual is no longer serving as an executive officer. This is a major change – once an employee is captured in the 162(m) net, they will be ensnared indefinitely. This would make post-termination payments that traditionally have been exempt from Section 162(m), including severance pay, retirement payments and deferred compensation, potentially non-deductible.
- The Bill would apply the Section 162(m) limitations to any corporations required to file SEC reports under Section 12 or 15(d) of the Securities Exchange Act of 1934. Thus, corporations required to file reports due to a public debt issuance would become subject to Section 162(m). This could impact private equity portfolio companies that register their debt with the SEC.

If enacted, the new Section 162(m) provisions would apply to tax years beginning after December 31, 2017.

Excise Tax on Excess Compensation Paid to Senior Executives of Tax-Exempt Organizations

The Bill would impose a new 20% excise tax on tax-exempt organizations for annual compensation in excess of $1 million paid to any of the organization's top five highest paid employees. The 20% excise tax would also apply to any "excess parachute payments" (generally defined as severance amounts equal to or exceeding three-times the employee's base compensation) paid by the tax-exempt organization to any such individuals.

Other Changes to Tax-Qualified Retirement Plans and Health and Welfare Arrangements

The Bill would make a number of changes to tax-qualified retirement plans:

- Defined benefit plans could permit in-service distributions for employees, beginning at age 59 ½, rather than at age 62 under current law.
- Defined contribution plans could permit hardship withdrawals from the portion of plan account balances attributable to employer contributions, and earnings on both employee and employer contributions (under current law, hardship withdrawals are limited to employee contributions net of earnings), and plans would no longer be required to suspend employee contributions for a period of six months following a hardship withdrawal.
- Terminating employees would no longer be required to roll over a defined contribution plan loan to an IRA within 60 days to prevent the loan from becoming a deemed distribution subject to taxation and a possible early withdrawal penalty.

- Nondiscrimination testing rules would be liberalized to expand cross-testing opportunities between an employer's defined benefit plans and defined contribution plans to help employers more easily satisfy nondiscrimination requirements.
- Traditional IRAs could no longer be recharacterized as Roth IRAs (and vice versa).

In addition, certain health and welfare benefit plans would be affected; notably, tax-favored dependent care assistance programs would be eliminated and Archer medical savings accounts would no longer be deductible or excludable.

For further information regarding the Bill and related tax rules applicable to executive compensation and other employee benefit arrangements, please contact a member of the Firm's Executive Compensation and Employee Benefits Practice Group.

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