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Executive Compensation and Benefits Alert

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Preparing for Tax Reform: The Current State of Play on Proposed Changes to Executive Compensation and Employee Benefits

On November 16, 2017, the House of Representatives voted to approve its version of the Tax Cuts and Jobs Act. The Senate is expected to vote on its version of the bill following the Thanksgiving break, which would require a reconciliation of terms with the House version in order to pass and become law.

With the House and Senate having released different versions of tax reform, it remains to be seen which, if any, of the proposals affecting executive compensation and employee benefits under the two versions will survive. That said, companies should give serious consideration to the impact of the changes under Section 162(m) of the Internal Revenue Code (Code), as this is one area of legislation in which the House and Senate bills are aligned. Companies should also be thinking about the impact of other proposed changes on their executive compensation and employee benefit programs, such as health care reform, fringe benefits provided to employees, technical rules regarding 401(k) and other retirement plans and, for private companies, the opportunity to permit employees to defer tax on options and restricted stock units (RSUs).

Current State of Play

The Tax Cuts and Jobs Act that the House approved on November 16, 2017, was an amended version of the one originally proposed on November 2, 2017 (collectively, the House Act). Also on November 16, 2017, the Senate Finance Committee approved its iteration of the Tax Cuts and Jobs Act (originally proposed on November 9, 2017, and subsequently amended) (collectively, the Senate Act), which will move to the full Senate for consideration. Below is a summary of the current state of play for key areas of executive compensation and employee benefits that would be impacted by the two bills.

Code Section 162(m). The House Act and the Senate Act contain the same proposed changes to the $1 million deduction limit under Code Section 162(m), including the scope of covered employees, elimination of the performance-based compensation and commission exceptions, and the new excise tax on covered employees of tax-exempt employers, except that the Senate Act adds a transition rule. The impact of these changes and planning strategies for public companies are discussed further below.

Affordable Care Act. The Senate Act repeals the individual mandate to obtain health insurance under the Affordable Care Act by reducing the tax penalty to zero beginning on January 1, 2019.

Deferred Compensation. The current law tax treatment of nonqualified deferred compensation, including Code Sections 409A, 457A and 457(f), would remain in effect under the House Act and the Senate Act. This comes as a big sigh of relief for many, as companies would otherwise have had to undertake a complete overhaul of their deferred compensation programs (including equity award grants, nonqualified retirement plans and severance arrangements) to comply with the changes to the timing of taxation that were proposed by the original versions of the bills and that were subsequently deleted.

Income Deferral Opportunity for Stock Options and RSUs Granted by Private Companies. Under both bills, qualifying employees of privately held companies would, under certain circumstances, have the opportunity to elect to defer the recognition of income from illiquid private company stock acquired in connection with the exercise of options or the settlement of RSUs for up to five years after the vesting of these awards if granted under a broad-based plan, effective for options exercised and RSUs settled after December 31, 2017. Given the limited scope and various technical requirements that would need to be satisfied in order to take advantage of this opportunity, many private companies may not view this as an effective tool for deferring income tax on options and RSUs, particularly considering that current and former CEOs and chief financial officers, the four highest-compensated officers in any of the 10 preceding taxable years and 1 percent owners at any time during the 10 preceding calendar years are precluded from making this election.

Limitations on Fringe Benefits. The House Act and the Senate Act propose changes to certain fringe benefits offered by employers to employees. The income exclusion for employer-reimbursed or -paid moving expenses would be repealed under both bills, while the tax status of other fringe benefits — such as dependent care assistance programs, employer-provided housing and employer-provided education assistance programs, as well as the deductibility for business entertainment, meals provided at the employer's convenience and transportation benefits — remains uncertain. If any of these changes are ultimately adopted, companies will need to revisit the fringe benefits offered to employees and consider making changes to benefits that are no longer tax-favored.

Technical Rules Regarding 401(k) and Other Retirement Plans. The House Act and the Senate Act include new provisions that impact retirement plans in areas such as retirement plan contribution limits, hardship distributions, permitted in-service distributions for defined benefit pension plans, nondiscrimination testing rules, an extended rollover period for plan loans and elimination of the ability to recharacterize a traditional IRA and Roth IRA. Note that the Senate Act no longer eliminates catch-up contributions for high wage employees as originally proposed. The proposed changes to retirement plans are generally intended to benefit sponsors and participants of retirement plans and may require changes in plan administration and amendments to governing plan documents.

Impact of Code Section 162(m) Changes on Public Companies

Under current law, Code Section 162(m) limits the deduction that public companies may take for annual compensation paid to the company's CEO and three other most highly compensated officers (other than the CFO) who are employed on the last day of the employer's fiscal year to $1 million per individual, subject to exceptions for qualified performance-based compensation and commissions. Both bills propose significant changes:

- The exceptions for qualified performance-based compensation and commissions would be eliminated, so that all compensation paid to a covered employee in excess of $1 million would be nondeductible;
- Covered employees subject to Code Section 162(m) would include the CEO and the CFO (including any individual who held either of these positions at any time during the taxable year) and the three other most highly compensated officers (other than the CEO and the CFO) for the taxable year. In addition, once an individual becomes a covered employee for any taxable year beginning after December 31, 2016, that individual will remain a covered employee under Code Section 162(m) for all future years, including after termination of employment and even death; and
- Companies subject to Code Section 162(m) would include corporations that have publicly traded debt; currently, only corporations with publicly traded equity are subject to Code Section 162(m).

The proposed changes under Code Section 162(m) would become effective for tax years after December 31, 2017. However, the Senate Act includes a transition rule under which the proposed changes would not apply to any compensation under a written binding contract that was in effect on November 2, 2017, that is not materially modified after that date. This transition rule is likely to be of limited use for many companies given its narrow scope.

Elimination of the Code Section 162(m) exceptions for qualified performance-based compensation and commissions would result in a significant lost tax deduction for companies that have come to rely on these exceptions in designing their executive compensation programs. While adding the CFO as a covered employee was not unexpected, expanding the scope of covered employees so that all compensation received from the company in future years would be subject to the $1 million limit is surprising and is expected to significantly impact the manner in which executive compensation programs are designed and implemented. However, if the corporate tax rate is ultimately reduced by tax reform legislation, this would soften the impact of the loss of the deduction taken by companies for compensation paid to executives.

If the proposed legislation under Code Section 162(m) is enacted into law, companies may expect to see changes in the following areas:

- The cost of compensating covered employees would significantly increase, as companies would not be able to rely on the commonly used exceptions for qualified performance-based compensation and commissions while at the same time the number of covered employees and their covered compensation could increase dramatically from current levels, particularly if there are frequent changes in the company's named executive officers;
- Despite the lost tax advantages of performance-based compensation, companies will continue to maintain performance-based compensation programs in response to the ever-increasing focus on pay-for-performance by proxy advisory firms and institutional shareholders, which has resulted in companies providing executives with a higher percentage of their total annual compensation in the form of contingent, performance-based compensation in recent years;
- Severance payments to covered employees would become subject to the $1 million deduction limit under the proposed rule. To mitigate the cost of a potential lost deduction, companies may consider whether it would be feasible or practicable to structure severance arrangements for covered employees to provide for payments of up to $1 million per year spread over multiple years; and
- One benefit from the proposed changes to Code Section 162(m) would be a reduction in cost and administrative burden from no longer having to comply with the strict rules for qualified performance-based compensation under Code Section 162(m), including the requirement that companies submit their performance-based compensation plans to shareholders for approval every five years, the complexity of designing performance targets and adjustments that are objectively determinable and the need to monitor the status of outside directors for purposes of awarding and administering qualified performance-based compensation.

To prepare for the proposed changes to Code Section 162(m), companies should analyze the cost of compensating individuals who may become covered employees under Code Section 162(m). In addition, companies should revisit those actions they may have previously taken to ensure that compensation qualifies for the performance-based compensation exception and consider whether any changes to compensation practices should be made in light of the elimination of this exception, such as using a Code Section 162(m) umbrella plan and subjecting what would otherwise be time-based RSUs to a performance condition.

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As Congress proceeds along the road of tax reform, we will continue to monitor developments affecting executive compensation and employee benefits and provide updates as additional information becomes known.

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