Client Alert

Tax Reform: The Shifting Landscape of Executive and Equity Compensation

The House and Senate propose wide-sweeping amendments to the tax rules regarding executive and equity compensation that would affect public and private for-profit companies as well as tax-exempt organizations.

11.17.17

By Pillsbury's Executive Compensation & Benefits Team

Tax reform, including changes to the taxation of executive compensation, is on the horizon as both the House and Senate move forward with legislative efforts. On November 16, 2017, the House passed its tax reform bill, the Tax Cuts and Jobs Act. The Senate released its own proposal on November 9, 2017, which was significantly changed by the Chairman's mark on November 14, 2017 and was approved with amendments on November 16, 2017. Over the past weeks, the House Bill and the Senate Proposal have become gradually aligned with respect to executive and equity compensation; however, significant differences remain.

TAKEAWAYS

- The House passes Tax Cuts and Jobs Act with substantive changes to the tax rules affecting executive compensation.
- The Senate proposal would make many of the same changes but expands the scope of the limitation on deductions for compensation in excess of $1 million and proposes a new excise tax on tax-exempt organizations.
- In light of the fluid legislative process, employers should stay abreast of changes and their possible implications for their compensatory arrangements.

Background

On November 2, 2017, the House of Representatives introduced its "Tax Cuts and Jobs Act," a tax reform bill that proposed to dramatically alter the tax treatment of executive and equity compensation. Before the ink was dry, on November 6, 2017, the Chairman of the House Ways and Means Committee, Kevin Brady, released amendments that scaled back some of the more far-reaching amendments proposed by the initial House bill. The House Ways and Means Committee approved the amendments on November 9, 2017 and sent the **revised bill** (the "House Bill") to the full House for a vote. The House passed its bill on November 16, 2017.

Amidst the commotion, on November 9, 2017, the Senate Finance Committee released its own tax reform proposal, "Description of the Chairman's Mark of the 'Tax Cuts and Jobs Act'." The mark-up process of the proposal lasted nearly a week and, on November 15, 2017, the Senate Finance Committee released its **current proposal** (the "Senate Proposal") which also eliminated certain wide-sweeping amendments included in the initial Senate tax reform proposal. The Senate Finance Committee approved its current proposal with minor additional amendments late on November 16, 2017. Both the House Bill and the Senate Proposal are anticipated to evolve as they move through the legislative process. The House Bill and the Senate Proposal have become increasingly aligned, although the table below reflects that key differences remain. If the Senate's Proposal is passed as it currently stands, it is anticipated that the differences would be reconciled in Conference.

The Proposed Laws

The table below summarizes key executive and equity compensation provisions of the House Bill and the Senate Proposal.

Changes Impacting Public and Private For-Profit Companies

EQUITY COMPENSATION	
Stock Options and Restricted Stock Units (RSUs):	
Current Law	• Non-qualified stock options (NSOs) that satisfy certain requirements are taxable as ordinary income upon exercise. • Incentive stock options (ISOs) are taxable at favorable long-term capital gains rates when the acquired shares are sold provided certain holding period requirements are met. • RSUs are taxable upon settlement (i.e., conversion into shares or cash), so long as the short-term deferral exemption of Section 409A of the Internal Revenue Code of 1986 (the "**Code**") applies or the Section 409A requirements are satisfied.
House Bill	Adds a new tax deferral opportunity for private company stock options and RSUs granted under broad-based plans: • Subject to certain requirements, eligible employees[1] may elect to defer the income tax from illiquid private company stock acquired in connection with the exercise of stock options or the settlement of RSUs for up to five years after the vesting of the awards. • Elections must be made within 30 days after the vesting date. • Employers must notify employees of the deferral election opportunity on or prior to the vesting date. • An option will not qualify as an ISO if an employee makes a deferral election for stock attributable to the ISO. • Applies to stock options exercised and RSUs settled after 12/31/2017.
Senate Proposal	Same as the House Bill.

Alternative Minimum Tax (AMT) on ISO Exercise:	
Current Law	The "spread" (i.e., the excess of the fair market value of the stock acquired on exercise over the aggregate exercise price) under an ISO is a tax adjustment item for purposes of calculating the AMT such that high-earners may incur AMT tax in the year of ISO exercise and, thus, significantly lose the tax deferral benefits of ISOs described above.
House Bill	• Eliminates AMT, making ISOs more attractive to high earners. • Applies to tax years after 12/31/2017.
Senate Proposal	Same as the House Bill.

CAP OF $1 MILLION TAX DEDUCTIBILITY FOR PUBLIC COMPANIES	
Current Law	Code Section 162(m) caps a public company's federal income tax deduction for compensation paid to any "covered employee" at $1 million in any taxable year, subject to exceptions for commissions and qualified performance-based compensation (including stock options and stock appreciation rights). • Covered employees are the company's CEO and next three most highly compensated officers (other than the CFO) at the end of the taxable year. • Applies to companies with publicly traded stock (which includes foreign companies traded through American Depositary Receipts (ADRs) that meet certain requirements).
House Bill	• Eliminates the exceptions for commissions and performance-based compensation. • Expands the scope of covered employees to include: – the company's CFO; and – any person who is a "covered employee" on or after 1/1/2017 for as long as that person (or his or her beneficiary) receives compensation even if the person no longer serves as an officer of the company. • Expands the scope of employers to include companies with publicly registered debt. • Applies to tax years after 12/31/2017.
Senate Proposal	• Same as the House Bill, but expands the scope of employers to include: – all domestic publicly traded corporations and foreign corporations traded through ADRs; and – large private C or S corporations that are not publicly traded. • Adds a transition rule such that the changes do not apply to compensation under a written contract that was in effect on 11/2/2017 and that was not materially modified after such date.[2]

Changes Impacting Tax-Exempt Organizations

EXCISE TAX ON COMPENSATION IN EXCESS OF $1 MILLION AND ON PARACHUTE PAYMENTS	
Current Law	No provision.
House Bill	• Imposes a 20% excise tax on the tax-exempt employer for payment of compensation in excess of $1 million to a "covered employee." Generally, all taxable compensation from the organization and certain related organizations is included in determining the $1 million limit. • Imposes a 20% tax on the tax-exempt employer for any compensation payment based on termination of employment (a "Parachute Payment") if the total payment equals or exceeds 300% of the employee's average pay for the prior five tax years, regardless of whether the payment exceeds $1 million. If the limit is exceeded, the tax applies to the amount of the Parachute Payment in excess of 100% of the employee's five-year average pay. • "Covered employees" include a person who is one the five highest paid employees for the taxable year or for any year after 2016. • Parachute Payments exclude payments received from a tax-qualified plan, 403(b) plan or 457(b) plan.
Senate Proposal	• Similar to the House Bill. • Senate clarifies that covered organizations include federal, state or local government entities.

TAXES ON EXCESS BENEFIT TRANSACTIONS	
Current Law	Code Section 4958 currently imposes a 25% excise tax on "disqualified persons" who engage in an "excess benefit transaction" with a public charity or social welfare organization. An organization manager who participates in an excess benefit transaction is also subject to a 10% excise tax unless the participation is not willful and is due to reasonable cause.
House Bill	No change.
Senate Proposal	• Imposes a 10% tax on the organization unless the participation is not willful and is due to reasonable cause. • Eliminates the rebuttable presumption of reasonableness based on advance approval by an authorized body, reliance on comparability data and concurrent documentation.[3] • Eliminates the special rule that treats an organization manager's participation as not "knowing" if the manager relied on professional advice. • Includes as disqualified persons: athletic coaches of most colleges, universities, vocational and other post-secondary schools, and investment advisors to all applicable tax-exempt organizations. Also expands the definition of an investment advisor. • Extends intermediate sanctions to organizations under Code Section 501(c)(5) (labor and certain other organizations) and Code Section 501(c)(6) (business leagues and certain other organizations). • Effective for taxable years after 12/31/2017.

COORDINATION OF LIMITS ON GOVERNMENTAL 457(B) PLANS	
Current Law	The annual deferral limit for an eligible deferred compensation plan under Code Section 457(b) is tested independent of deferrals for the same employee under a 401(k) or 403(b) plan. In addition, special catch-up contributions may be made to a governmental 457(b) plan in the last 3 years before attaining normal retirement age.
House Bill	No change.
Senate Proposal	• The Senate Proposal would impose a single aggregate annual limit for deferrals under a governmental 457(b) plan and deferrals for the same employee under a 401(k) or 403(b) plan. • The special catch-up rules which allow for increased annual deferrals to a governmental 457(b) plan are repealed.

Practical Considerations

It is essential that employers continue to closely monitor progress on Congress's tax reform effort, be educated and be prepared to respond to changes as they arise. The bill adopted by the House and amendments proposed by the Senate reflect significant changes over the past two weeks and we expect that they will continue to do so as we approach year-end. That being said, Republican Party leaders controlling the House and the Senate have expressed a strong desire for enactment of reforms within a matter of weeks. When a final law is passed, please contact the Executive Compensation team at Pillsbury for guidance on how to comply with the new tax law and take advantage of new planning opportunities.

For a summary of changes contemplated by the House Bill and the Senate Proposal to the taxation of employee benefits, see our alert "**A Moving Target: Tax-Qualified Plans and Other Employee Benefits.**"

Susan P. Serota | Partner
Leader, Executive Compensation & Benefits Practice
New York | +1.212.858.1125
susan.serota@pillsburylaw.com

Executive Compensation & Benefits Team:

Benjamin H. Asch, Danielle Bradley, Howard L. Clemons, Peter J. Hunt, Mark Jones, James P. Klein, Justin Krawitz, Colleen Lamarre, Kevin Lin, Jessica Lutrin, Lori Partrick, Christine L. Richardson, Matthew C. Ryan, Cindy V. Schlaefer, Amber A. Ward, Marcus Wu

1 Eligible employees exclude the company's current or former CEO or CFO or any person who, during the prior 10 years, was a 1% owner of the company or one of the four highest-compensated employees.

2 The Senate Proposal includes as an additional requirement to qualify as grandfathered that the compensation be vested on or before 12/31/2016. This additional requirement was not included in the amendments released on November 16, 2017.

3 The rebuttable presumption is regularly used by applicable tax-exempt organizations to protect against excess benefit claims. The elimination of the presumption will be a significant concern for tax-exempt organization board members.

Pillsbury Winthrop Shaw Pittman LLP
FS_v.11.17.17