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Client Alert

Employee Benefits & Executive Compensation

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House Bill Includes Significant Changes to Executive Compensation Aspects of the Internal Revenue Code

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On November 2, 2017, the House of Representatives released H.R. 1, the Tax Cuts and Jobs Act (the "Bill"). The Bill contains significant changes to executive compensation rules in the Internal Revenue Code of 1986, as amended (the "Code") that, if enacted, could radically alter the executive compensation landscape. It is important to remember that nothing has been enacted, and if the Bill is enacted, it may differ (perhaps significantly) from the version proposed. Key proposed changes include:

Nonqualified Deferred Compensation

The Bill would strike Section 409A of the Code and replace it with a new Section 409B. Section 409B would provide that any amount deferred under a nonqualified deferred compensation plan will be includible in gross income when there is no substantial risk of forfeiture (i.e., when the compensation becomes vested).

Under 409B, there would only be a substantial risk of forfeiture if compensation is conditioned on the future performance of substantial services. Achievement of performance targets would not constitute a substantial risk of forfeiture, nor would a covenant not to compete. This would mean that in order to defer taxation of compensation until the time of payment, continued service would be a required condition.

The Bill's definition of "nonqualified deferred compensation" includes stock options, stock appreciation rights, and rights to compensation based on the value (or increase in value) of equity units of a service recipient, such as certain phantom equity plans. Transfers of property (such as restricted stock) would be excluded from the definition of nonqualified deferred compensation.

Currently, under Section 409A, stock options are not considered nonqualified deferred compensation if, among other requirements, their exercise price is at least fair market value on the date of grant. It remains to be seen whether a similar exemption will be included under Section 409B. The Bill does provide that an amount would not be treated as deferred if it is paid no later than two and one-half months after the end of the year in which it is no longer subject to a substantial risk of forfeiture.

Section 409B would be effective for amounts attributable to services performed after 2017. Existing deferral arrangements would need to be reviewed to determine whether such arrangements may trigger accelerated income tax under 409B. There would be a limited transition period to amend current arrangements to align payment timing with the time of income inclusion.

Deferred amounts that are attributable to 2017 or earlier would be includible in gross income in the later of (i) the last taxable year beginning before 2026, or (ii) the taxable year in which there is no substantial risk of forfeiture.

Compensation Deductions for Public Corporations

Currently, Section 162(m) of the Code provides that publicly held corporations can deduct up to $1 million per year for compensation payable to any "covered employee" (which, in general, includes the Chief Executive Officer and the next three highest compensated officers (other than the Chief Financial Officer)). However, the $1 million limit does not apply to "qualified performance-based compensation," which is compensation payable solely on account of the attainment of one or more pre-established, objective performance goals, nor does the $1 million limit apply to compensation paid on a commission basis.

Under the Bill, the exceptions for performance-based compensation and commissions would be repealed (so that each would count against the $1 million limit). In addition, the definition of "covered employee" would be revised to include the Chief Executive Officer, the Chief Financial Officer, and the three other highest paid employees. Moreover, once an employee qualifies as a covered employee, the $1 million limit would apply to that person for so long as the company pays remuneration to him or her (or to his or her beneficiaries).

Tax-Exempt Organizations

Under the Bill, a tax-exempt organization would be subject to a twenty percent excise tax on remuneration in excess of $1 million per year paid to any of its five highest paid employees. The employer would be liable for payment of this tax. As with the proposed changes to 162(m), once an employee qualifies as a covered person, the excise tax would apply to compensation paid in excess of $1 million per year to that person as long as the organization pays him or her remuneration.

Alternative Minimum Tax

The Bill would repeal the alternative minimum tax, under which taxpayers with income above certain thresholds pay income tax equal to the greater of (i) their regular income tax, and (ii) their alternative minimum tax liability.

Other Deductions Limited or Repealed

The Bill would make a number of other changes to compensation related deductions, including (i) limiting an exclusion for employer-provided housing to $50,000, and (ii) repealing exclusions from income for employee achievement awards, amounts provided under employer-provided dependent care assistance programs, qualified moving expense reimbursements, adoption assistance programs, and employer-provided education assistance programs.

Retirement Plans

Although there had been speculation that the Bill would reduce the maximum annual 401(k) contributions an employee may make, the Bill did not include such a limitation. The Bill would make various minor changes to retirement plans, such as requiring the IRS to adopt guidance allowing employees who take hardship withdrawals to continue making contributions to their plans.

Conclusion

The Bill is the first draft of a tax bill that will surely change as the legislative process continues. There is much to watch in the coming days and months, but in the interim, taxpayers should be aware of the potentially dramatic changes looming in the executive compensation sphere.

Contacts

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