THE
NATIONAL LAW REVIEW

# Changes on the Horizon for Executive Compensation?

Wednesday, November 8, 2017

On November 2, 2017, House Republicans introduced the Tax Cuts and Jobs Act (the "House Bill"). If enacted in its current form, the House Bill would make dramatic changes to the landscape of executive compensation for for-profit and tax-exempt non-governmental employers. This alert covers key aspects of the proposed executive compensation changes in the House Bill.

The Senate is working on its own version of the legislation, which may differ significantly from the House version. Also, the House Bill is currently in the "mark-up" period, which may result in changes to the bill.

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## Deferred Compensation of For-Profit Employers

### How does the House Bill affect existing deferred compensation arrangements for for-profit entities?

The House Bill would add a new Section 409B to the Internal Revenue Code of 1986 (the "Code"). Under Section 409B, deferred compensation that relates to services performed in 2018 and later years will be taxed upon vesting (*e.g.*, when the compensation is no longer subject to a substantial risk of forfeiture). In contrast, the current tax rules of Section 409A of the Code allow for delaying the imposition of federal income tax until payment without regard to when vesting occurs.

### What is a substantial risk of forfeiture?

A "substantial risk of forfeiture" would exist if the individual's compensation is conditioned upon the future performance of substantial services. A covenant not-to-compete or the occurrence of a condition related to a purpose of the compensation *other than* the future performance of services (such as the completion of an initial public offering) would not, by itself, suffice as a substantial risk of forfeiture.

### Does the House Bill include a grandfathering provision?

Yes, the House Bill provides a limited grandfathering provision. Deferred compensation attributable to services performed before 2018 would be includible in income by the later of:

- The last taxable year beginning before 2026, or
- The taxable year in which the individual vests in the deferred compensation (i.e., the taxable year in which the deferred compensation is no longer subject to a substantial risk of forfeiture).

### What about equity compensation?

Equity compensation and equity-based compensation such as stock options, stock appreciation rights, restricted stock units and performance stock units would be considered deferred compensation and, presumably, would be taxed upon vesting. The federal income tax treatment for restricted stock would remain unchanged; restricted stock would continue to be taxed upon vesting under Section 83 of the Code.

### Does the House Bill permit the accelerated payment of deferred compensation relating to services performed before 2018?

Yes. The House Bill requires the Secretary of Treasury to issue additional guidance within 120 days after the enactment of the Tax Cuts and Jobs Act, providing for a limited period of time during which a nonqualified deferred compensation arrangement may be amended to permit payment at the time that the deferred amounts are required to be included in income under the new rules.

### When would these changes take effect?

If the House Bill is enacted as currently drafted, the deferred compensation changes described above would generally apply to amounts attributable to services performed after December 31, 2017.

## The $1 million deduction limit under Section 162(m) of the Code

### Does the House Bill affect exemptions to the $1 million deduction limit under Section 162(m) of the Code?

Section 162(m) of the Code prohibits a public company from deducting compensation paid to a "covered employee" in excess of $1 million per year. Currently, the $1 million dollar deduction limit does not apply to performance-based compensation or to remuneration payable on a commission basis. The House Bill would repeal the performance-based compensation exception and the exception for remuneration payable on a commission basis.

### Are there changes to the individuals who are subject to Section 162(m)?

Currently, the IRS considers an employee to be a "covered employee" if the employee was serving as the company's chief executive officer (*i.e.*, the principal executive officer or PEO) as of the close of the tax year or was one of the company's three highest compensated employees whose compensation is required to be reported to the shareholders (*other than* the PEO or the company's chief financial officer). This means that, currently, the chief financial officer of a public company is not considered a "covered employee" for purposes of the $1 million deduction limit of Section 162(m) of the Code. The House Bill changes this. The House Bill would apply the $1 million deduction limit to a company's chief financial officer and to any employee who was a covered employee in any preceding tax year beginning after December 31, 2016.

### How about the entities that are subject to Section 162(m)?

The House Bill would apply the $1 million deduction limit to companies that are required to file reports with the SEC under Section 15(d) of the Securities Exchange Act, such as a company that issues debt securities to the public.

### When would these changes take effect?

If the House Bill is enacted as currently drafted, the Section 162(m) changes employers would apply to taxable years beginning after December 31, 2017.

## Executive Compensation of Tax-Exempt Employers

### Does the House Bill affect deferred compensation plans of tax-exempt employers?

Nonqualified deferred compensation arrangements sponsored by tax-exempt employers are currently governed by Section 457(b) of the Code ("eligible" deferred compensation plans"), Section 457(f) of the Code ("ineligible" deferred compensation plans) and Section 409A of the Code, in the case of a 457(f) plan.

Under the House Bill, Sections 457(b) and 457(f) of the Code would not apply to compensation deferred that is attributable to services performed after December 1, 2017. This change would affect only non-governmental tax-exempt employers.

### Is there a new excise tax on executive compensation paid by a tax-exempt employer?

The House Bill provides for a 20 percent excise tax on certain executive compensation paid by an entity that is exempt from tax under Section 501(a) of the Code. The excise tax would equal 20 percent of the sum of (i) the compensation paid by the entity to any covered employee in excess of $1 million, plus (ii) the amount of any “excess parachute payment” paid by the entity to any covered employee. This tax would be imposed on the employer.

A “covered employee” for purposes of this tax would include an employee who was among the organization’s five highest compensated employees in the current taxable year or who was a covered employee for any preceding taxable year beginning after December 31, 2016. The House Bill defines an “excess parachute payment” as an amount equal to the excess of any “parachute payment” over the employee’s “base amount” (the employee’s average annualized compensation from the employer over the five calendar years preceding his or her separation from service). An amount would be a parachute payment if it is contingent on the employee’s separation from employment and the present value of the compensation equals or exceeds three times the employee’s base amount. For purposes of this tax, “compensation” means an employee’s wages for federal income tax purposes under Section 3401(a) of the Code (excluding any Roth contributions).

**When would these changes take effect?**

If the House Bill is enacted as currently drafted, the changes for tax-exempt employers would apply to taxable years beginning after December 31, 2017.