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Alert

House Tax Reform Bill: Potential Dramatic Changes for U.S. Compensation Arrangements

November 7, 2017

The Tax Cuts and Jobs Act (the "House Tax Reform Bill"), introduced by House Committee on Ways and Means Chairman Kevin Brady (R-TX) on Nov. 2, 2017 (and amended on Nov. 3 and Nov. 6), proposes changes to the Internal Revenue Code of 1986, as amended (the "Code"), that would have dramatic effects on U.S. compensation arrangements.

The Death of Deferred Compensation — New Section 409B
The most monumental change affecting compensation under the House Tax Reform Bill is that it appears to supersede Code Section 409A with a new Code Section 409B. Like Code Section 409A, Code Section 409B addresses nonqualified deferred compensation arrangements. However, unlike Code Section 409A, which allows for the deferral of payment and taxation of vested compensation subject to compliance with specific requirements, Code Section 409B simply would eliminate the ability to defer taxation of vested nonqualified deferred compensation arrangements. Under Code Section 409B, an employee would be taxed on compensation, including most stock options and stock appreciation rights ("SARs"), when it is no longer subject to a "substantial risk of forfeiture" (i.e., vested) — regardless of when the compensation is payable, if it is actually ever paid or whether the employer's obligation to pay the compensation is funded.

Important aspects of Code Section 409B:

- *Stock Options and SARs*. Unlike Code Section 409A, which provides an exemption for stock options and SARs granted with an exercise/strike price equal to fair market value, most companies' stock options and SARs would be treated as deferred compensation and subject to Code Section 409B. Accordingly, the unique tax advantage of those stock options and SARs — the ability to delay income tax on vested awards until exercised — would be eliminated. There is one new limited exception included in the House Tax Reform Bill. The new tax provision would permit an employee (other than a CEO, CFO and certain highly compensated officers) of certain private companies to elect to defer tax on vested "Qualified Equity Grants" for up to five years. The election only applies to awards of stock options and restricted stock units relating to illiquid stock granted by a company that has never been public and has granted such awards to at least 80 percent of the company's employees (excluding the CEO, CFO and certain highly compensated employees) during the calendar year. The amount of income recognized by the employee at the end of the deferral period would be based on the value of the stock on the vesting date, even if the value of the stock has declined.

- *Other Equity Awards*. In addition to stock options and SARs, Code Section 409B generally would apply to all forms of equity-based compensation other than restricted stock and profits interests. As a result, except for the Qualified Equity Grants (described above), a person would be taxed on the value of an equity award whenever vested, which, like Code Section 409A, could be at grant if the holder can become vested upon his or her "retirement" or involuntary termination for "good reason" (depending on the definition of good reason).
- *Short Term Deferrals*. Unlike Code Section 409A, the exception from deferred compensation for "short term deferrals" would be narrowed under Code Section 409B only to amounts paid by the 15th day of the third month following the end of the employer's taxable year in which the right to the compensation vested. Code Section 409A contains a broader exception for amounts paid by the 15th day of the third month following the end of the later of the employer's taxable year and employee's taxable year.
- *Severance Benefits*. Under Code Section 409A, if an employee has the right to severance benefits upon an involuntary termination for "good reason," depending on the definition of good reason, the severance benefits could constitute deferred compensation, but the taxation could be deferred until termination of employment by complying with the Code Section 409A deferral requirements. Under Code Section 409B however, such severance would be deemed vested and taxable to the employee at the time that he or she became subject to the agreement or arrangement. In addition, even if an employee is only entitled to severance benefits upon an involuntary termination (i.e., termination without "cause"), the employee would be subject to accelerated taxes on any portion of those severance benefits that are paid after the 15th day of the third month following the end of the employer's taxable year — the portion that isn't a short term deferral (regulations would need to specify if the employee would be taxed on the termination date or a later date before the 15th day of the third month following the end of the employer's taxable year).
- *Vesting*. Like Code Section 409A, compensation is subject to a "substantial risk of forfeiture" if the person's rights are conditioned upon his or her future performance of substantial services. However, unlike Code Section 409A, the occurrence of a condition related to a purpose of the compensation other than the future performance of services does not render such compensation subject to a "substantial risk of forfeiture."
- *Non-Competes*. Like Code Section 409A, a right to compensation would not be subject to a "substantial risk of forfeiture" solely by reason of a covenant not to compete. As a result, under Code Section 409B, an employee would be taxed on any vested compensation that his or her employer mandatorily defers to ensure compliance with restrictive covenants.
- *Withholding*. While Code Section 409A generally obligates employers to report deferred compensation, employers are not responsible for withholding the penalty taxes imposed under Code Section 409A. In contrast, because Code Section 409B would cause employees to have taxable income upon vesting, employers would be required to satisfy their tax withholding obligations with respect to any compensation that is treated as no longer being subject to a substantial risk of forfeiture under Code Section 409B. Significantly, despite the withholding requirement, it appears that the employer would not be entitled to a deduction for the compensation until it is actually paid.

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New Section 409B would be effective with respect to compensation earned (and, presumably, first becoming vested) after Dec. 31, 2017. An employee's compensation that is attributable to services performed before 2018 would be grandfathered from Code Section 409B but must be taxable to the employee by the later of the last taxable year beginning before 2026 and the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation. In addition, Sections 457A and 457(f), which cover certain compensation arrangements with tax indifferent employers, would be repealed with respect to compensation attributable to services performed after 2017.

Section 162(m) — $1 Million Compensation Deduction Cap — No More Exceptions

Under current Code Section 162(m), a publicly held corporation — a corporation with common equity securities required to be registered under Section 12 of the Securities Exchange Act of 1934 (the "Exchange Act") — generally may not deduct the compensation paid during a taxable year to any of its "covered employees" that is in excess of $1 million. The one major exception under Code Section 162(m) that is commonly used by publicly held corporations is the unlimited deduction for "performance-based compensation." The House Tax Reform Bill would amend Code Section 162(m) to eliminate the exception for performance-based compensation, and no compensation paid to a covered employee above $1 million would be deductible. Also, the House Tax Reform Bill would expand the coverage of Code Section 162(m) by:

- Amending the definition of "publicly held corporation" to remove the limitation that it applies only to issuers of common equity and to include any corporation that is required to file reports pursuant to 15(d) of the Exchange Act. Accordingly, corporations with only public debt would be become subject to Code Section 162(m).
- Amending the definition of a "covered employee" to include any person who:
  - Served as a chief executive officer or chief financial officer (previously excluded due to a "glitch" in the law) at any time during a year (not just the last day of the year), or
  - Was a covered employee for any preceding taxable year beginning after Dec. 31, 2016.

The changes to Code Section 162(m) would be effective starting in 2018 and would appear to apply to performance-based compensation granted prior to 2018 but paid in 2018 or later.

20 Percent Excise Tax on Excess Tax-Exempt Organization Compensation

The House Tax Reform Bill would also add a new Section 4960 that, starting in 2018, would impose an excise tax on any tax-exempt organization on compensation paid to any employee who is one of the organization's five highest-compensated employees for the taxable year or who was a covered employee for any preceding taxable year beginning after Dec. 31, 2016, equal to 20 percent of:

- The employee's compensation in excess of $1 million and
- The employee's "excess parachute payments" — any severance payments in excess of three times the employee's average taxable compensation over the past five years ("base amount").

Now What?

Although the Republican-controlled Congress intends to push to enact the House Tax Reform Bill in the short time before the end of the year, it may undergo significant changes before being passed, if ever. However, given the ground-shaking changes in the House Tax Reform Bill that would dramatically affect

U.S. compensation arrangements if the House Tax Reform Bill were enacted in its current form, or if any bill similar to it were enacted, and how soon those changes could become effective, employers should stay aware of the progress and possible evolution of the House Tax Reform Bill over the coming weeks.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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