



Compensation  
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# The Tax Cut and Jobs Act

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The House Ways and Means Committee released its long anticipated proposal on tax reform, the “Tax Cuts and Jobs Act” on November 2, 2017. If passed, the bill would go into effect in 2018. Notably, the bill is lengthy and complex, weighing in at a whopping 426 pages! Our early read indicates that the compensation related provisions of the Act would result in profound change.

The major provisions of the bill involve tax reform and simplification resulting in a total revenue reduction of \$1.5 trillion from 2018 to 2027.

Key Provision of the Tax Cut and Jobs Act
Permanent reduction in corporate tax rate from 35% to 20%
Consolidation and simplification of individual tax rates by moving from 7 brackets to 4 brackets of 12%, 25%, 35% and 39.6%
A portion of income generated by a pass through entity taxed at a maximum rate of 25%, with safeguards to prevent re-characterization of wages as business income
Repeal of personal exemptions
Increase in standard deduction
Increase in credit against estate tax and repeal of estate tax in 2024
Elimination of Alternative Minimum Tax

In order to stay within the \$1.5 trillion allowance approved by the Senate, the House had to work hard to build in provisions that accelerate income and raise revenue. There is also a strong populist impulse to deliver on the administration's promise of a middle class tax cut. The jury is still out on whether the House has delivered a bill that will pass and become law.

At minimum, the Act provides insight on how the political establishment perceives executive compensation. The rationale that the House articulated for the new executive compensation provisions includes:

- Repeal of benefits that are generally only available to highly compensated employees;
- Simplification of the tax code; and
- Desire to limit perverse consequences caused by executives who focus on short-term, quarterly results rather than the long-term success of companies.

Several provisions of the bill have very significant implications for executive compensation. If these provisions are enacted we expect large scale change to occur. Highlights are summarized below with more detailed discussion following:

Section	Compensation Related Provisions of the Tax Cut and Jobs Act	Projected Revenue Impact Over 2018-2027
3801	Accelerate taxation of Nonqualified Deferred Compensation, including stock options and other forms of equity compensation	\$16.2 billion increase
3802	Limit tax deductibility of compensation over \$1 million for top 5 highest paid Named Executive Officers	\$9.3 billion increase
3803	20% excise tax on compensation in excess of \$1 million for five highest paid employees in tax-exempt organizations	\$3.6 billion increase

Section	Compensation Related Provisions of the Tax Cut and Jobs Act	Projected Revenue Impact Over 2018-2027
1501 -1506	Technical amendments to simplify and reform savings, pension and retirement, related to repeal of Roth recharacterizations and loosening of regulations related to in-service distributions, hardship distributions, rollovers and nondiscrimination testing	\$14.3 billion increase
Total		\$43.4 billion increase

None of these provisions have a big impact on the bottom line. The total increase of \$43.4 billion in projected revenues represents a paltry 0.3% of the \$1.5 trillion price tag, a mere 30 basis points. But if these provisions become law, we can confidently predict lots of change in executive compensation plans as the implications are better understood.

## Section 3801

### Accelerate taxation of Nonqualified Deferred Compensation (NQDC), including stock options and other forms of equity compensation.

This provision calls for a major change to the tax treatment of NQDC. NQDC would be taxed as soon as the compensation is *no longer subject to a substantial risk of forfeiture, defined as when receipt of the compensation is not subject to future performance of substantial services*. In other words taxation would occur at vesting, rather than upon payment or settlement. Performance conditions would not constitute a substantial risk of forfeiture.

NQDC is defined broadly to include any plan or individual arrangement that provides deferred compensation, other than qualified employer plans and bona fide vacation leave, sick leave, compensatory time, disability pay or death benefit plans. Surprisingly, the bill wraps equity compensation under NQDC, specifically including any arrangement that provides the value of, or the appreciation in value of, a specified number of equity units (whether paid in cash or stock), stock options and stock appreciation rights.

This tax treatment would change practically all forms of executive compensation:

- Complex rules governing NQDC under 409A would be eliminated
- Elective deferrals of compensation would be eliminated.
- SERPs, severance benefits and other non-qualified retirement plans would be taxed at vesting, making lump sum distributions the only practical solution.
- Stock options and stock appreciation rights would be taxed at vesting, rather than at exercise.
- To the extent that performance conditions applied to cash or equity compensation, service-based vesting would also be required to avoid early taxation.
- Performance share units and long-term cash awards would continue without adverse tax consequence under the proposed rules, provided the vesting period aligned with the performance period.
- Performance plans with installment vesting or plans that allow executives to bank a portion in the first year of a multi-year performance period would need to be reassessed to ensure that early taxation is not triggered.
- The tax code would provide a strong incentive to companies to pay current cash and service-based restricted stock

The proposed tax treatment of stock options seems particularly ill-advised. It is not clear how it would work and there are a number of aspect that would potentially create serious unintended consequences. For example, if the in-the-money value of options were indeed taxed as ordinary income at the vesting date of the option, there would be a strong incentive to grant options that vest immediately. If an option vested on the date of grant, there would be no in-the-money value and taxes would be zero. Assuming no change in the tax code,

an executive would establish basis for capital gains on the vesting date and all future appreciation would be treated as a capital gain. We don't believe that the House Ways and Means Committee intended this outcome. More clarity on how stock options would be treated and even better, a different treatment for stock options, is needed.

The new rules would apply for compensation attributable to services performed after 2017. Current tax treatment would apply to existing non-qualified deferred compensation until 2025, when the new rules would apply to all compensation arrangements.

## Section 3802

### **Limit tax deductibility of compensation over \$1 million for top 5 highest paid Named Executive Officers.**

This provision would expand current limits on tax deductibility of executive compensation over \$1 million by eliminating the exceptions for commissions and performance-based compensation, including stock options. The new limits on deductibility would align with SEC disclosure requirements by including the principal executive officer, the principal financial officer and the next three highest paid executive officers. Notably, once an individual executive is subject to the deduction limit, the limit would continue to apply as long as the employer pays compensation to the executive or any beneficiaries.

This provision certainly would raise the after-tax cost of senior executive compensation, but we don't expect compensation to decline. We believe most companies would simply absorb the cost. One positive implication is the elimination of all the time and energy devoted to complying with Section 162(m) as currently written.

## Section 3803

### **20% excise tax on compensation in excess of \$1 million for five highest paid employees in tax-exempt organizations.**

Under the provision, tax-exempt organizations would be subject to a new 20% excise tax on compensation over \$1 million paid to any of its five highest paid employees. This would create greater parity with the tax treatment afforded public companies and discourage excessive compensation in tax-exempt organizations.

## Sections 1501-1506

### **Technical amendments to simplify and reform savings, pension and retirement, related to repeal of Roth recharacterizations and loosening of regulations related to in-service distributions, hardship distributions, rollovers and nondiscrimination testing.**

The new tax rules generally left the core benefits available under 401(k) plans untouched. Current limits on contributions remain intact. Instead a series of technical amendments will loosen some of the current rules governing in-service distributions, hardship distributions, rollovers and nondiscrimination testing.

We will see how the public, corporate America, and importantly, the Senate react to the House's bill in the coming days. We will keep our readers informed of new developments.



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