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Proposed Tax Bill Retains Some Provisions that Impact Exec Pay; Here's What You Should Know

As the House passed its version of the tax bill and the Senate process moves forward, several provisions in the legislation addressing executive pay have been deleted while others remain.

Update: The Senate passed its version of the tax bill in the early morning of December 2. The final versions of both the House and Senate bills preserve the expanded restriction on 162(m), however the Senate bill provides transition relief (for binding arrangements entered into on or before November 2, 2017). Congressional leaders will now work to reconcile their versions and bring forth a final bill that President Trump is expected to sign. The Senate and House are still divided over numerous areas concerning both individual and corporate tax provisions, including some that the Senate put in its bill at the last minute.

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On November 16, 2017, the full United States (US) House of Representatives passed its version of the Tax Cuts and Jobs Act. On the same day, the Senate Finance Committee passed its version of the tax bill that will go before the full Senate. Sections of the bill that would have made major changes to the treatment of stock options and non-qualified deferred compensation had been removed from the bill on November 9 and later removed from the Senate version. Under the version passed by the House, the current treatment of stock options and non-qualified deferred compensation would be preserved.

Nonetheless, both the Senate and House bills include adverse changes to Section 162(m). However, the Senate version includes important transition relief that will somewhat soften the blow if it survives in any final bill. These provisions are not likely to affect the overall design of most compensation programs nor materially impact companies' income statements, but modest adjustments might help avoid inadvertent tax expenses.

We will continue to monitor these bills as they go through the legislative process and will update this alert when significant events or changes occur. The final form of the bill remains uncertain. Some of the discussion about this tax reform legislation has turned to the political aspects of which provisions will survive through the process, and whether the legislation, as it might be modified, can garner enough votes in the Senate. Below we detail the provisions that address executive compensation that are in the final House bill and Senate committee bill:

Section 162(m): No Tax Deductibility of Compensation Over $1 Million for CEO and Select NEOs

As proposed, companies' deductions for executive compensation paid to named executive officers (proposed to now include the CFO) would be limited to $1 million per year, with no exceptions for performance-based compensation. The limit would apply to amounts received from stock options, SARs, performance shares, PSUs, RSUs, various forms of nonqualified deferred compensation and severance payouts and certain retirement benefits.

Both versions of the bill would apply to any individual who was or who became a Sec. 162(m) "covered person" after the 2016 reporting year, and such individual would remain a covered person for as long as he or she receives compensation from the company.

If this provision goes into effect, there could be lost tax benefits and effects on a company's income statement. It will be even more important for companies to be mindful of the timing of vesting and payout to avoid inadvertent bunching of items into the same time period, causing a loss of deductibility.

This provision would be effective for tax years beginning after December 31, 2017. The IRS could issue further regulations or guidance to address existing deferrals, among other things.

The Senate version of the bill has an important transition rule: the proposed changes would not apply to compensation that was subject to a binding contract on November 2, 2017, and was no longer subject to a substantial risk of forfeiture (i.e., effectively vested) on December 31, 2016. If this transition rule doesn't make it into any final bill, companies could be subject to a larger one-time expense caused by reversing accrued tax assets.

Tax-Exempt Organizations: Compensation Over $1 Million Paid to Certain Individuals

The bills also provide that if a tax-exempt organization pays compensation to any of its five most highly compensated employees in excess of $1 million (subject to certain exclusions), the organization would be liable for a 20% tax on excess amounts. This provision would apply to amounts paid after December 31, 2017. Like the amended Section 162(m) provision, if an individual became a covered person under this section, such individual would remain a covered person for as long as he or she receives compensation from the organization.

The bill also imposes a 20% tax on excessive amounts contingent on separation from service paid to such covered employees. This provision is somewhat similar to the golden parachute change-in-control provisions under Section 280G— that is, it only applies if the present value of the contingent amounts does not exceed three times the employee's average taxable wages during the preceding five year period. This provision does not apply to amounts paid under Section 457 or qualified plans.

Next Steps

Given the continuing uncertainty surrounding the tax landscape at this critical time of year, we recommend taking the following steps to best position your organization for potential changes:

- Keep in mind that the bill is likely to change, even at this later stage.

- Monitor the changes to the bill and consider how they could impact your various compensation programs and practices.
- Advise the members of your organization and your board of directors of the status and developments as you monitor the situation.
- Consult with others in your company or organization with respect to potential tax, accounting and financial reporting implications of the tax reform bill. Also consider whether there would be any impact on your 2018 earnings guidance to the investment community.
- Consider delaying changes to existing programs until the landscape becomes clearer unless you absolutely need to take action due to other factors (e.g., timing of shareholder meetings).
- Think about whether your organization would benefit from joining any advocacy or lobbying efforts to seek changes to the draft legislation.
- As the year draws to a close, consider whether there are any prudent moves to make, and remember to advise others in your company or organization to ensure their availability to execute such moves.

To speak with a member of our compensation consulting group about the proposed tax bill and related changes to executive compensation, please write to consulting@radford.com.

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