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Practice Update

Tax Reform Bill Guts Executive Compensation Benefits

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On November 2, 2017, United States Representative Kevin Brady (R-TX), Chairman of the Ways and Means Committee, introduced the Tax Cuts and Jobs Act (the Act), the Trump Administration's much-heralded tax reform effort. In addition to some of the more widely-discussed changes to individual and corporate tax rates, standard deductions, and more, the Act makes substantial changes to non-qualified deferred compensation arrangements (which may include bonus, severance, equity, and phantom equity arrangements), and would impose new limits on payments to the highest-paid executives of public and tax-exempt entities. While the Act shies away from the previously reported 401(k) contribution reductions, the House's proposed changes are poised to revolutionize executive compensation.

Substantial Restrictions on Deferred Compensation

Currently, deferred compensation arrangements are governed by Section 409A of the Internal Revenue Code of 1986, as amended (the Code). Code Section 409A and its regulations impose significant limits on how deferred compensation arrangements are structured. This provision is extremely complicated and its application is very far-reaching.

The Act fundamentally changes this structure by introducing Code Section 409B, which prohibits

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deferred compensation for services performed after December 31, 2017, by requiring such compensation to be included in gross income once it is no longer subject to a substantial risk of forfeiture (i.e., once vested). For these purposes, the right to compensation is subject to a substantial risk of forfeiture only if "conditioned upon the future performance of substantial services." For services performed on or before December 31, 2017, existing deferrals arrangements will be phased out, with deferred compensation included in gross income by the *later of*: (i) the last taxable year beginning before 2026, or (ii) the taxable year in which the amounts vest. These rules also extend the definition of deferred compensation to include equity-based arrangements (including stock options and stock appreciation rights).

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- These proposed changes do not apply just to traditional deferred compensation plans; indeed, many common compensation arrangements, such as bonus plans, severance agreements, phantom equity plans, and equity incentive plans are implicated by these changes. For example, proposed Section 409B could necessitate the following adjustments to common compensation structures:
    - Bonus arrangements that are earned in one year, but are paid in the following year to allow an employer to finalize its financial statements, will need to be restructured.
    - Stock option grants will now require immediate inclusion of income as the options vest (although House Republications have indicated that a specific exception will be available for closely-held corporations in later versions of the bill).
    - Severance arrangements that provide for payments in installments over several years,

rather than in a lump sum, will no longer be possible.

- If the Act becomes law, we suspect that the IRS will incorporate certain exemptions to these provisions in subsequent clarifying regulations.

Expansion of Deduction Limits under Code Section 162(m)

Under the current Code Section 162(m), a publicly-held company may only deduct up to $1 million of compensation to certain covered employees – the company's chief executive officer and the next three highest-paid compensated officers (excluding the chief financial officer) as of the end of the taxable year – but that limit is undercut by exceptions for certain common types of executive compensation, such as commissions and performance-based compensation (e.g., options), as well as payments to tax-qualified retirement plans, and other amounts that are excludible from gross income.

The Act proposes amendments that would eliminate the exceptions for commission-based and performance-based compensation and modify the list of covered employees to consist of the company's chief executive officer, chief financial officer, and the next three highest-paid officers at any point in any taxable year beginning after December 31, 2016.

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- Many publicly-held companies have historically relied on the performance-based exemption under Code Section 162(m). The loss of this exemption may not ultimately result in companies restructuring their performance-based compensation arrangements, despite the lost deduction, since many institutional investors have come to expect these arrangements. In addition, the proposed reduction of corporate tax rates under the Act may help to somewhat counteract the lost benefit.

- Companies that have utilized the current rule that a covered employee was determined on the last day of the taxable year to structure severance arrangements in excess of $1 million should be aware that this planning option is no longer available.
- Gain on stock options, previously exempt as performance-based compensation, would now be included in the $1 million deduction limit.

New Limits on Tax-Exempt Entity Compensation Arrangements

Tax-exempt organizations have traditionally enjoyed freedom from certain limits on compensation that apply to for-profit corporations. Under the Act, tax-exempt organizations would now become subject to taxation for certain compensation paid to the five highest-compensated employees of the organization in excess of certain thresholds. First, tax-exempt organizations (rather than the employees) would be subject to a 20% excise tax on compensation to one of these individuals in excess of $1 million. In addition, the organization may be subject to a 20% excise tax on certain severance arrangements that are considered “excess parachute payments.” For these purposes, a parachute payment is a compensation payment that (i) is contingent on the employee’s separation from employment, and (ii) exceeds three times the employee’s base amount (that is, the average of the employee’s annualized compensation for the five most recent taxable years that end before the employee’s separation from employment). *Excess* parachute payments are those that exceed the base amount.

In addition to the above, Section 457(b) and Section 457(f) plans, used to defer executive compensation in tax-exempt entities, will no longer be available for those entities with respect to amounts deferred for services performed after December 31, 2017. This means that amounts deferred pursuant to those plans will be immediately taxable at the time they

are no longer subject to a substantial risk of forfeiture.

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- Universities, hospital systems, public utilities, and other large nonprofit entities with significant executive compensation arrangements should be especially attuned to these developments. For example, this rule change may be potentially impactful for university coaches who often have compensation arrangements in excess of the $1 million threshold.

Next Steps for Employers

Although there are many more steps in this legislative process, we recommend that employers take the following steps to prepare:

- Employers should continue to monitor changes that may be made to the proposed tax bill in the days and weeks to come.
- Employers should review their compensation arrangements to anticipate what changes may need to be made if these compensation-related provisions (or something like them) are eventually passed.
- Consideration should also be made as to whether there may be strategic planning opportunities in anticipation of the proposed January 1, 2018 general effective date.

Although the task of analyzing current compensation arrangements may seem daunting, employers do not have to tackle this job alone. As members of Akerman's Employee Benefits and Executive Compensation Practice Group continue to monitor this fluid situation closely, we have developed a Tax Reform Advance Compensation Advisory Service. The Advance Compensation Advisory Service is an employer-

centric service available on a flat fee basis that includes:

- Meetings with C-Suite executives to provide educational background and strategic insights on the potential changing landscape of the benefits and compensation area;
- Guidance on specific items of likely interest to the company to monitor or plan for in the very short-term;
- The compilation of a detailed written inventory of all of the company's existing employment agreements, deferred compensation arrangements, and other plans/policies that could be impacted by federal tax reform efforts.

Please contact Leanne Reagan at leanne.reagan@akerman.com or 305-982-5644 or Peter Salomon at peter.salomon@akerman.com or 305-982-5567 with any questions, either in the coming days and weeks as this particular legislation continues to evolve, or in the longer term, as possible subsequent attempts to modify executive compensation tax structures proceed. Additional information about the Advance Compensation Advisory Service, including about its flat fee price and scheduling availability, is available upon request.

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