House Proposal on Tax Reform

On November 2, 2017, the House Republicans issued a sweeping tax reform bill that generally adheres to the themes of President Trump's previous tax proposals, except that it includes a number of surprises involving executive compensation. Generally, the proposed changes to the Internal Revenue Code ("Code") would be effective for tax years beginning after 2017.

Highlights of Tax Proposal

- Executive officer annual pay in excess of $1 million would be non-deductible, without exception.
- Nonqualified deferred compensation (which would include certain equity awards such as stock options) would be subject to tax upon vesting, not settlement or exercise, as applicable.
- Top corporate income tax rate would fall from 35% to 20%.
- Accumulated foreign earnings would be deemed repatriated and subject to preferred tax rates.
- Generally, future foreign earnings would be exempt from U.S. corporate income tax.
- Business income from certain pass-through entities would be subject to a flat income tax rate of 25%.
- Alternative minimum tax applicable to businesses and individuals would be repealed.
- Number of individual income tax brackets would be reduced but the top individual rate would remain at 39.6%, which would apply to taxable income over $1 million for married taxpayers filing joint returns.
- Standard deduction would increase to $24,000 from $12,700 for joint filers.

President Trump hopes to have a tax reform bill to sign by Thanksgiving. We believe that this timeframe is overly optimistic, given that the legislative process on the bill has just begun. Further, while House Republicans may be able to muster up a majority to pass the bill (or some version of the bill), the same is not necessarily true in the Senate. The bill will fail in the Senate if more than two Republican Senators oppose it.

If enacted, the proposed tax bill would revise large portions of the current Code. This Client Update provides highlights of these revisions in the following three areas:

- Executive Compensation
- Corporate Income Tax
- Individual Income Tax

Proposed Tax Provisions Relating to Executive Compensation

The tax proposal includes the following two surprising provisions relating to executive compensation:

- **Tax deduction on "covered employee" pay limited to $1 million annually.** Under Code Section 162(m), a public corporation generally may deduct compensation paid or accrued with respect to a "covered employee" up to $1 million per year. The deduction limitation under current law does not apply to "performance-based compensation," such as stock options and performance awards linked to the achievement of shareholder approved performance metrics. Currently, a covered employee means any individual who, on the last day of a public corporation's taxable year is the corporation's principal executive officer or among the three highest compensated officers (other than the principal executive officer and excluding the principal financial officer) whose compensation is required to be disclosed in the corporation's proxy.

  The tax proposal would make the following substantial modifications to Code Section 162(m):

  — Eliminate the exception to the $1 million deduction cap for performance-based compensation.

  — Revise the definition of a covered employee to include the principal financial officer.

  — Once an individual qualifies as a covered employee, the deduction limitation would apply to that person so long as the corporation pays remuneration to such person (or to any of that person's beneficiaries).

- **Modification of the treatment of nonqualified deferred compensation.** Under current law, the tax treatment of nonqualified deferred compensation is governed by Code Section 409A and the "constructive receipt" doctrine. Under these rules, nonqualified deferred compensation is not subject to federal income tax until the year received by the employee (with the employer taking a deduction for such compensation in the same year). However, failure to comply with the complex rules under Code Section 409A (i) subjects the nonqualified deferred compensation to federal income tax in the year in which it becomes vested and (ii) imposes a 20% penalty tax.

  The tax proposal would significantly change the tax treatment of nonqualified deferred compensation. Under Section 409B, an employee would be taxed on deferred compensation once the compensation is no longer subject to a substantial risk of forfeiture. The tax bill would limit the definition of substantial risk of forfeiture to conditions tied to the future performance of services. The following conditions would not be treated as constituting a substantial risk of forfeiture:

  — Covenant not to compete, or

  — Condition that relates to a purpose of the compensation other than the future performance of services (e.g., to create an incentive to achieve a specified performance goal).

  In defining a nonqualified deferred compensation plan, proposed Section 409B does not adopt the expansive definition of a nonqualified deferred compensation plan used in Code Section 409A. Instead, Section 409B would define a nonqualified deferred compensation plan as:

  — Any plan that provides for the deferral of compensation (subject to certain narrow exceptions), and

  — Any plan that grants time-based and performance-based restricted stock units, stock appreciation rights and nonqualified stock options.

If the tax bill is enacted, regulations would be required to flesh out the full scope of Code Section 409B.

The tax proposal relating to nonqualified deferred compensation would be effective for compensation attributable to services performed after 2017. This suggests that legacy equity awards with service-based vesting requirements that extend beyond December 31, 2017 could become subject to proposed Section 409B. For example, if a nonqualified stock option vested ratably over three years was granted on July 1, 2016, then presumably the tranches that vest on July 1, 2018 and July 1, 2019 would be subject to Code Section 409B.

The current tax rules would continue to apply to existing nonqualified deferred compensation arrangements until the last tax year beginning before 2026, when such arrangements would become subject to the new tax requirements.

Meridian Comment. The proposed sweeping changes in Code Section 162(m) and in the tax treatment of nonqualified deferred compensation have caught most (if not nearly all) practitioners and companies off-guard. These changes, if enacted, would have significant consequences for executive compensation programs. Complicating matters is the timing of the tax bill. Generally, calendar year companies approve equity grants and set performance metrics for incentive awards in the first quarter of the year. These companies and their compensation committees would have little time to adjust pay and retirement programs to reflect the new tax environment if the tax bill should be enacted this year and become effective in 2018.

To assist companies and compensation committees in understanding the implications of the proposed tax bill if enacted, we have prepared the following guide regarding the potential effects of the executive compensation provisions on certain compensation and retirement programs.

Proposed changes to Code Section 162(m) ($1 million deduction limit on executive officer compensation)

For nearly 35 years, public companies have tried to balance the often competing goals of maximizing the tax deductibility of compensation paid to executive officers and maintaining flexibility in plan design and pay decisions. The passage of the tax bill would mean public companies would no longer be concerned about structuring executive officer compensation in ways to maximize its deductibility under Code Section 162(m). The absence of such concern may lead to a number of outcomes (besides a higher tax bill), some of which are discussed below.

- **Potential changes in plan/award designs.** Public companies would be able to include the following features in incentive plans/awards without regard to the consequences under Code Section 162(m):

  — Subjective performance metrics;

  — Discretionary authority to (i) adjust payouts, (ii) modify the determination of achieved performance and (iii) make mid-performance period adjustments of any kind (including adjustments to performance goals); and

  — Automatic guaranteed payouts on account of a participant’s involuntary termination without cause or voluntary termination for good reason.

  However, whether any of these potential designs are appropriate would depend upon a company’s given facts and circumstances, market practice and governance considerations. In addition, some items would have accounting implications if embedded in performance share awards.

- **Potential changes in Compensation Committee oversight of incentive arrangements.** Compensation committees would no longer be bound to comply with the following procedural aspects of Code Section 162(m): (i) approving performance goals within the first 90 days of the performance period, (ii) certifying performance results, and (iii) approving equity grants. However, as a matter of sound corporate governance, we would anticipate that compensation committees would continue to maintain significant oversight of incentive and equity plan arrangements.

- **Changes in equity plan documents.** Equity plans would no longer need to include provisions relating to Code Section 162(m), such as the annual per participant limit on equity and cash awards, the listing of performance metrics, and the prohibition on the exercise of upward discretion. In addition, public companies would no longer need to obtain shareholder approval of performance metrics every five years.

Proposed changes to treatment of nonqualified deferred compensation

The proposed changes to the treatment of nonqualified deferred compensation plans would have a sweeping effect on the landscape of executive compensation, some of which are outlined below.

- **Effect on nonqualified stock options ("NSOs").** Current NSO designs would likely be severely challenged by the tax proposal. Under the tax bill, NSOs would be taxed in the year of vesting and likely each year thereafter until exercised. Presumably, this means the in-the-money value of a vested NSO on the vesting date (and annual incremental increases in the in-the-money value of an unexercised and vested NSO) would be subject to tax as ordinary income. Since the option would not yet be exercised, the holder would be in the unenviable position of recognizing income for tax purposes without actually receiving the income.

  An alternative design approach that could breathe life back into NSOs would be to grant options that are automatically exercised and settled after a relatively lengthy vesting schedule, such as 5-year cliff vesting (stock-settled SARs could also work under this design). This would allow an employee holding an NSO to capture share price appreciation over a fixed period, but avoid income recognition prior to settlement.

- **Effect on performance share units ("PSUs").** Generally, PSUs would not be affected by the tax proposal under most plan designs (other than the Section 162(m) issues highlighted above; also see below "Effect on Retirement Vesting Provisions"). PSUs that require an employee to be employed through the date of payout would not be problematic under the tax proposal. Alternatively, PSUs that vest at the conclusion of a performance period would not be problematic as long as the PSUs were paid within the short-term deferral period. However, if a PSU should provide for mid-performance period vesting (e.g., due to death or disability), the tax proposal would require immediate recognition of income upon such vesting date, irrespective of whether the amount of payout is based on actual performance for the entire performance period. The tax bill does not provide a methodology for determining the amount of income to be recognized under the foregoing circumstance.

- **Effect on time-based restricted stock units ("RSUs").** Generally, time-based RSUs would not be affected by the tax proposal under most designs (though see below "Effect on Retirement Vesting Provisions"). Often, an RSU is settled upon vesting at which time the fair market value of the underlying shares is includible in taxable income. This is consistent with the treatment time-based RSUs would receive under the proposed tax bill. However, RSUs would no longer have a post-vesting tax deferral opportunity under the proposed bill.

  RSUs that accelerate vesting upon death, disability or a change in control would also comply with the requirements under the tax bill as long as the settlement of the RSUs coincided with the vesting event or occurred within the "short-term deferral period." The short-term deferral period ends on the first March 15th following the date of the vesting event**.**

- **Effect on restricted stock awards.** The proposed tax bill would not affect the tax treatment of restricted stock awards, which would remain governed by Code Section 83. Similar to the requirements of the proposed tax bill applicable to nonqualified deferred compensation, Code Section 83 already provides that property, such as employer stock, becomes subject to tax when the property is no longer subject to a substantial risk of forfeiture (or, if earlier, when the property becomes transferrable).

- **Effect on retirement vesting provisions.** The inclusion of a retirement vesting provision in incentive plans and/or award agreements would likely be rendered obsolete by the tax proposal. Typically, a retirement vesting provision provides that upon an employee's defined "retirement", the employee would vest or continue to vest in all or a portion of the employee's applicable equity award. In such a case, the equity award would not be subject to taxation until settled, assuming that the award is a derivative instrument such as a restricted stock unit. In the case of restricted shares, under current law, the attainment of retirement eligibility already triggers immediate income recognition.

  Under the proposed tax bill, an employee who attains retirement eligibility presumably would be treated as vested in an equity award at the first time he or she becomes eligible for retirement, irrespective of whether the employee actually retires. If an employee became retirement eligible prior to or at the time an equity award is granted, then the employee would be treated as immediately vested in the award at the time of grant and would recognize taxable income at that time. If the employee met the requirements for retirement after the grant date, then the employee would be treated as vested in the award at that later time.

- **Effect on severance benefits.** The proposed tax bill would significantly affect severance benefits paid in installments. Generally, severance benefits (whether paid in cash or in kind) are taxed when paid. This is true even where the benefits are paid in installments over a multi-year period. However, under the proposed tax bill, once an employee incurs a triggering event for severance benefits (e.g., involuntary termination without cause), the employee would be treated as vested in his or her severance benefits. In the case where cash severance is paid in installments, the employee would be required to immediately recognize in income the full value (or perhaps the present value) of his or her future cash severance benefits. Presumably, this would be true for all forms of severance benefits, such as continuation of health and welfare benefits.

  Typically, public companies pay general cash severance (not in connection with a change in control) in installment payments. These payments provide an incentive for a separating employee to comply with restrictive covenants (e.g., non-compete, non-solicitation) when severance benefits are contingent on such compliance. However, for companies to avoid placing a separating employee in an adverse tax position, they would be forced to pay severance in a lump sum, rather than installments if proposed Code Section 409B is enacted. With the possible loss of severance benefits no longer available to incent a separating employee's compliance with restrictive covenants, companies would be required to consider other means to encourage compliance such as the inclusion of recoupment provisions in severance plans and agreements.

- **Effect on nonqualified retirements plans.** The tax bill would upend the very purpose of nonqualified retirement plans: to accumulate amounts on a tax deferred basis for later distribution and taxation. The effect the tax bill would have on specific types of nonqualified retirement plans is described below:

  — <u>Elective Deferral Plans</u>. Elective deferral plans would be rendered obsolete since executives (and outside directors) would no longer have the ability to elect to defer vested compensation (e.g., base salary, earned bonus, etc.) on a pre-tax basis.

— Restoration Plans and Supplemental Executive Retirement Plans ("SERPs"). Most restoration plans and many SERPs would likely become problematic as a participant's benefit accrual would become subject to tax once vested, with presumably annual incremental increases subject to tax. Since benefits under these plans are often subject to immediate or short-term vesting, the plans no longer would be an effective vehicle for accumulating benefits on a tax-deferred basis.

However, certain modifications to restoration plans and SERPs may enhance their utility even in the face of the tax bill's treatment of deferred compensation. For example, a restoration plan or SERP could subject accrued benefits to a relatively lengthy vesting schedule (e.g., 10-year cliff vesting), thereby deferring taxation on benefit accruals during the entire vesting period. Upon vesting, benefits would be paid. However, executives may not be in favor of such designs.

Alternatively, restoration plans and SERPs could be designed to (i) payout vested amounts each year to cover a participant's tax liability, with the net after-tax amounts remaining in the plan (or, held in a secular trust) or (ii) pay out amounts yearly, in lieu of accruing amounts under such plans.

Proposed Provisions on Corporate Income Tax

The following are highlights of the proposed provisions on corporate income tax.

- **Reduction in corporate tax rate.** The tax rate on corporate income would fall from 35% to 20%.
- **Elimination of taxation on worldwide income (move to territorial tax system).** Currently, a U.S. corporation's worldwide earnings are subject to U.S. corporate tax. Under the tax proposal, a foreign subsidiary's dividends paid to its U.S. parent corporation would not be subject to U.S. corporate income tax. For a foreign subsidiary's dividend to be exempt from taxation, the U.S. parent corporation must own at least a 10% stake in the subsidiary.
- **Reduction in corporate tax rate applicable to accumulated foreign earnings.** Under current law, foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. parent corporation. Under the tax proposal, accumulated foreign earnings would be deemed distributed to the U.S. parent corporation. The portion of the foreign earnings comprising cash or cash equivalents would be taxed at a reduced rate of 12%, while any remaining foreign earnings would be taxed at a reduced rate of 5%. Corporations, at their election, would have up to eight years to pay the tax liability in equal annual installments.
- **Elimination of the Corporate Alternative Minimum Tax (AMT).** Corporate AMT would be eliminated under the tax proposal.
- **Acceleration of deduction for capital investments.** Businesses would be allowed to immediately deduct the cost of "qualified property" acquired and placed in service after September 27, 2017 and before January 1, 2023. Currently, deductions for cost of qualified property is amortized over a specified period of years based on type of property.
- **Partial limitation on deduction for net interest expense.** The deduction for net interest expense would be disallowed to the extent the interest expense exceeds 30% of a business's adjusted taxable income. Currently, business interest generally is allowed as a deduction in the taxable year in which the interest is paid or accrued, subject to a number of limitations.
- **Elimination of deduction for entertainment and other expenses.** Under the tax proposal, no deduction would be allowed for entertainment expenses and a broad range of other expenses including those related to amusement or recreation activities or facilities (e.g., skyboxes), or for amenities provided to an

employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business. Currently, businesses may deduct up to 50% of these expenses.

- **Modification on net operating loss (NOL) carryover/carryback.** Businesses would be able to deduct an NOL carryover or carryback up to 90% (currently 100%) of a business's taxable income (determined without regard to the NOL deduction).

- **Repeal of certain business credits.** A broad range of business credits would be repealed including employer-provided childcare credit, the work opportunity tax credit and the oil recovery credit

Meridian comment. If enacted, the tax bill would appear to be a boon to corporate America. Many corporations are likely to see significant increases in after-tax income, which in turn could drive share price. Further, corporations would be able to repatriate and invest foreign earnings in the U.S. without substantial tax consequences. In setting future performance goals relating to income-derived metrics, such as earnings per share or after-tax income, companies and compensation committees should remain mindful of the tax proposals effect on those performance outcomes.

Proposed Provisions on Individual Income Tax

The following are the highlights of proposed provisions on individual income tax.

- **Reduction in number of tax brackets but top marginal rate remains unchanged.** The number of tax brackets would fall from seven to four but the top marginal rate would remain at 39.6%. In addition to the 39.6% rate, the other three marginal rates would be 12%, 25% and 35%. The proposal also would change the income tax brackets, with the top marginal rate kicking in at $1 million for married taxpayers filing joint returns.

- **Increased standard deduction.** The standard deduction for a married couple filing jointly would almost double from $12,700 to $24,000. For a single taxpayer, the standard deduction would increase from $6,350 to $12,000.

- **Elimination of personal exemptions.** The tax proposal would eliminate the personal exemption, which currently is $4,050 per exemption, subject to phase-out.

- **Elimination of partial phase-out on itemized deductions.** The partial phase-out on itemized deductions for high income taxpayers would be eliminated under the tax proposal.

- **Modification of certain itemized deductions.** The tax proposal would modify the following itemized deductions:

  — Mortgage interest. Currently, interest payments on up to $1 million in acquisition indebtedness (i.e., home mortgage) is deductible on a taxpayer's principal residence and one other residence. For debt incurred after November 2, 2017, the tax bill would reduce the $1 million to $500,000 and would limit the interest deduction to a taxpayer's principal residence. Interest on home equity loans incurred after November 2, 2017 would no longer be deductible.

  — Real estate tax. Currently, there is no limit on the deduction for real estate taxes. Under the tax bill, the deduction for real estate taxes would be limited to $10,000 per year.

  — State and local tax. The deduction for State and local taxes would be eliminated except in the case where such taxes were incurred in carrying on a trade or business or producing income.

— Charitable contributions. Generally, the deduction for charitable contributions would be preserved under the tax proposal, subject to certain modifications.

- **Elimination of certain itemized deductions.** The tax proposal would eliminate the following itemized deductions:

  — Personal casualty losses (subject to limited exceptions).

  — Tax preparation fees.

  — Medical expenses.

  — Moving expenses associated with starting a new job.

  — Employee expenses attributable to a trade or business.

- **Elimination of alternative minimum tax (AMT).** The tax proposal would repeal AMT for individuals.

- **Increase in credit against estate, gift and generation-skipping transfer tax; future repeal of estate and generation-skipping transfer taxes**. The basic exclusion against estate, gift and generation-skipping transfers would be doubled from $5 million (as of 2011) to $10 million, which is indexed for inflation. Beginning after 2023, the estate and generation-skipping taxes would be repealed under the tax proposal.

- **Special tax rate on pass-through business income.** Currently, income from pass-through entities (e.g., partnership income, Subchapter S income) is treated like wages for tax purposes. Under the tax proposal, a special 25% flat tax rate would apply to "business income" derived from a pass-through entity. The 25% tax rate would be applied to 100% of net income derived from a passive business activity (i.e., owners/shareholders are not actively involved in the operation of the business) and generally would apply to 30% of the net business income derived from active business activities. Generally, the special 25% tax rate would not apply to personal services businesses (e.g., business providing services in the fields of law, accounting, consulting, engineering and financial services).

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.