Senate Proposal on Tax Reform

On the heels of the House tax proposal, the Senate Republicans released their own tax reform proposal on November 9, 2017. The Senate tax proposal departs from the House Republicans' tax proposal in several significant respects, including with regard to the effective date of the change in corporate tax rates. Generally, the Senate Republicans' proposed changes to the Internal Revenue Code ("Code") would be effective for tax years beginning after 2017. However, under the Senate tax proposal, the change in the corporate income tax rate would first become effective in 2019, while under the House tax proposal this change would first become effective in 2018.

Highlights of Senate Tax Proposal

- Same provisions on executive compensation that were included in the initial House tax proposal:
  - — Named 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) generally would be subject to tax when it is no longer subject to a substantial risk of forfeiture (i.e., upon vesting under a service condition), rather than upon settlement or exercise, as applicable (this provision has been struck from the House tax proposal).
- 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 17.4%.
- Alternative minimum tax applicable to businesses and individuals would be repealed.
- Number of individual income tax brackets would remain at seven.
- Top individual tax rate would fall from 39.6% to 38.5%, which would apply to taxable income over $1 million for married taxpayers filing joint returns.

We expect further changes to be made in both the House and Senate tax proposals. Ultimately, any differences between the House and Senate proposals would need to be addressed during the reconciliation process.

This Update first summarizes the Senate tax proposal's provisions relating to executive compensation and then compares the House and Senate tax proposals on corporate and individual income taxes.

Provisions Relating to Executive Compensation

The Senate tax proposal includes the ***same*** provisions on executive compensation that were part of the initial House tax proposal: (i) change in tax treatment of nonqualified deferred compensation and (ii) modification to Code Section 162(m). These proposed changes to the Code are briefly discussed below. Please refer to our Client Update dated November 7, 2017 for a detailed summary and analysis of these proposed changes.

Proposed Change in Treatment of Nonqualified Deferred Compensation

Like the initial House tax proposal, the Senate tax proposal would require nonqualified deferred compensation (NQDC) to be subject to tax when such compensation is no longer subject to a substantial risk of forfeiture. Included in the definition of NQDC would be certain equity awards, such as restricted stock units, performance share units, performance units, nonqualified stock options and stock appreciation rights. The proposed changes in the tax treatment of NQDC would substantially affect the design and, in some cases, viability of certain compensation and retirement programs.

As we previously reported, late last week the proposed provisions related to NQDC were deleted from the House tax proposal. Therefore, it was somewhat of a surprise to see these provisions included in the Senate Republican's tax proposal. However, given when the respective tax proposals were released, it would appear that the Senate Republicans simply replicated the provisions from the House tax proposal before they were deleted from the proposal. This suggests the absence of a champion for the NQDC provisions among Senate Republicans.

The open question is whether the Senate Republicans will follow the actions of their House colleagues and remove the NQDC provisions from the Senate tax proposal. This question may be answered as soon as this week. If the status quo is left unchanged, then the fate of the NQDC provisions would be decided during the reconciliation process.

Proposed Modification to Code Section 162(m)

Like the House tax proposal, the Senate tax proposal would make the following modifications to Code Section 162(m):

- Eliminate the exception to the $1 million deduction cap for performance-based compensation (e.g., compensation linked to the achievement of shareholder-approved performance metrics, grant of compensation committee approved nonqualified stock options).
- Revise the definition of a covered employee to include the principal financial officer (in addition to the principal executive officer and three highest-paid proxy-disclosed officers other than the principal executive officer and principal financial officer).
- Once an individual qualifies as a covered employee, the $1 million deduction cap would apply to that person so long as the corporation pays remuneration to such person (or to any of that person's beneficiaries).

The proposed modification to Code Section 162(m) would be effective for taxable years beginning after December 31, 2017.

The proposed modification does not explicitly grandfather compensation paid to a covered employee after the effective date but that was earned over a multi-year performance or service period that began before the effective date. Without statutory or regulatory relief, arguably incentive compensation earned under currently outstanding performance cycles (including performance cycles ending on December 31, 2017) but paid after December 31, 2017 could be subject to the proposed modification to Code Section 162(m).

Comparison of House and Senate Tax Proposals on Corporate Income Tax

The chart below compares key elements of the House and Senate tax proposals on corporate income tax.

Provision	House Bill	Senate Bill
Proposed Tax Rates and Earnings Subject to U.S. Corporate Income Tax		
Corporate tax rate	20% (effective 2018)	20% (effective 2019)
Income subject to tax	Moves to territorial tax system	Same as House Bill*
Foreign earnings	Excludes foreign earnings from U.S. corporate income tax, with exceptions	Same as House Bill*
Alternative Minimum Tax	Repeals	Same as House Bill*
Proposed Special Treatment of Foreign Earnings Accumulated Prior to Effective Date		
Held in cash/cash equivalents	Deems repatriated and subject to a 14% tax rate (reflects new tax rate in amendment to House Bill)	Deems repatriated and subject to a 10% tax rate
Reinvested in business	Deems repatriated and subject to a 7% tax rate (reflects new tax rate in amendment to House Bill)	Deems repatriated and subject to a 5% tax rate
Proposed Changes in Corporate Tax Deductions		
Limit on deduction for compensation paid to named executive officers (Code Section 162(m))	Disallows deduction for annual compensation paid to named executive officers (including CFO) in excess of $1 million, without exception	Same as House Bill*
Capital investments	Allows immediate deduction of the cost of “qualified property” acquired and placed in service after September 27, 2017 and before January 1, 2023	Same as House Bill*
Cap on deduction for net interest expense	Limits deduction for net interest expense to 30% of a business’s adjusted taxable income	Same as House Bill*
Net operating loss (NOL)	Allows deduction for NOL carryover or carryback to 90% of a business’s taxable income	Allows deduction for NOL carryover to 90% of a business’s taxable income Eliminates NOL carryback
Local lobbying expense	Disallows deduction for lobbying expenses relating to legislation before local governmental bodies	Preserves deduction for local lobbying expense
Entertainment expense	Disallows deduction for entertainment and related expense	Same as House Bill*
Proposed Changes in Business Credits		
Business credits	Repeals broad range of business credits including employer-provided childcare credit, the work opportunity tax credit and various energy-based credits	Preserves most business tax credits

*Denotes that the Senate tax proposal is substantially similar to the House tax proposal; however, certain differences not disclosed may exist between the two proposals.

Comparison of House and Senate Tax Proposals on Individual Income Tax

The chart below compares key elements of the House and Senate tax proposals on individual income tax.

Provision	House Bill	Senate Bill
Proposed Tax Rates on Income, Estates and Pass-Through Entities (effective 2017)		
Tax brackets and top tax rate	Reduces number of tax brackets from 7 to 4, with a top rate of 39.6% on taxable income in excess of $1 million for joint filers	Preserves 7 tax brackets, with a top rate of 38.5% on taxable income in excess of $1 million for joint filers
Alternative minimum tax	Repeals	Same as House Bill
Estate and gift tax	Increases exemption to $10 million; repeals estate and gift tax after 2023	Same as House Bill (but no future repeal)
Tax rate on pass-through entity net business income	25% flat tax rate (generally, 30% of net business income taxed at flat rate with remaining 70% taxed as wages)	17.4% flat tax rate on "qualified business income"
Proposed Treatment of Deductions, Exemptions and Exclusions from Income		
Standard deduction	Married couples filing jointly: $24,000 Single filers: $12,000 (CPI adjusted starting in 2018)	Married couples filing jointly: $24,000 Single filers: $12,000 (CPI adjusted starting in 2019)
Personal exemption	Repeals	Same as House Bill
Employer reimbursed moving expenses	Repeals exclusion from income of employer-reimbursed moving expenses	Same as House Bill
Moving expenses in connection with new job (unreimbursed)	Repeals deduction from income for unreimbursed moving expenses	Same as House Bill
Dependent care assistance (DCA)	Repeals exclusion from income of employer-reimbursed DCA expenses	Preserves exclusion from income of employer-reimbursed DCA expense
Proposed Treatment of Itemized Deductions		
Phase-out of itemized deduction on high earners	Repeals	Same as House Bill
Mortgage interest	Limits interest deduction to first $500,000 of indebtedness, and only on primary residence Eliminates interest deduction on home equity loans	Preserves current law which allows interest deduction on first $1 million of indebtedness Eliminates interest deduction on home equity loans
Real estate tax	Limits deduction to $10,000 per year	Repeals
State and local tax	Repeals for individuals, preserves deduction when State or local tax incurred in carrying on a trade or business or producing income	Same as House Bill
Charitable contributions	Preserves deduction for charitable contributions, with limited modifications	Preserves deduction for charitable contribution deduction and increases allowable deduction
Medical expenses	Repeals	Preserves
Other itemized deductions	Repeals following itemized deductions: ▪ Personal casualty losses (with limited exceptions) ▪ Tax preparation fees ▪ Employee expenses attributable to a trade or business	Same as House Bill but also repeals miscellaneous itemized deductions to the extent they exceed, in the aggregate, 2% of taxpayer's AGI

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